Optimization of Tax Sovereignty and Free Movement

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Optimization of Tax Sovereignty and Free Movement

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Preface

After having obtained my law degree at Leiden University in October 1998, I was approached by Tanja Bender and Kees van Raad, my former teachers in international tax law, to teach that subject in Leiden and to write a dissertation in that area. Since I had enjoyed both the topic of international tax law and the academic environment at Leiden University very much, I gladly accepted their offer. The topic of my research became the tax treatment of cross-border employment under the OECD Model Tax Convention and I published several articles on it. After some one and a half years I realized, however, that I wanted to broaden my legal horizon before really writing a book on the subject. In 2000 I was appointed as a legal clerk with the Dutch Supreme Court (*Hoge Raad*). I decided to put the taxation of cross-border workers on ice and to concentrate fully on my new tasks.

My academic interest was awakened again in 2002. In that year I was asked to write a preliminary report for the Dutch Association of Tax Research (*Vereniging voor Belastingwetenschap*) on the delimitation of the Dutch corporate income tax jurisdiction on the basis of the 'nationality' of the company. After having completed and defended this report[1], I considered the idea of using it for a PhD. thesis and to keep the taxation of cross-border workers on ice still. In 2004 this idea became concrete when I left the Dutch Supreme Court to teach again at Leiden University and to prepare a dissertation there. I also became a part-time tax advisor with PricewaterhouseCoopers, where I started working with PwC's EU Direct Tax Group which focuses on the EU law aspects of direct taxation. Obviously, these aspects were also present in the provisional topic of my dissertation: the delimitation of a State's tax jurisdiction on the basis of nationality. Would such a delimitation be in line with EU law? During the course of my initial research on the delimitation of a State's direct tax jurisdiction and the compatibility thereof with EU law, I came across the copious literature which relates in one way or the other to this problem. Terms such as discrimination, dislocation, fragmentation, disparity and economic and juridical double taxation were frequently used, without their content having been clearly defined. Nevertheless, I noted that the ECJ was criticized heavily in various publications for not complying with alleged principles of (international) tax law or its own earlier case law.[2] I came to the conclusion that clarity in this discussion was needed first. This has resulted in the present research, aimed at developing a theoretical assessment model for reviewing direct tax cases which is independent of the case law and literature published so far. This model makes both a normative claim (how should the ECJ assess whether a certain tax measure is compliant with the EU free movement provisions?) and a descriptive claim (the model is able to explain why the ECJ arrives at certain conclusions in its case law and is able to structure the ECJ's case law in a coherent manner).

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1 Douma 2002.

2 See for a discussion Douma 2006.

It will be clear that the tax treatment of cross-border employment under the OECD Model Tax Convention will remain on ice. Fortunately, I can refer to the dissertation of Frank Pötgens for an excellent study on the taxation of income from international private employment.[3]

Many people have contributed to the completion of this dissertation. Some of them require special mention here. First, I would like to thank my supervisors Prof. Tanja Bender and Prof. Frank Engelen for their unconditional support and friendship. The many conversations and discussions we have had on the topic of my dissertation remain a great inspiration. My special thanks must also go to Prof. Axel Cordewener, Prof. Malcolm Gammie, Prof. Janneke Gerards and Prof. Peter Wattel for finding the time to read my manuscript as members of the PhD Committee. Their comments and suggestions for improvement have been invaluable for the completion of this dissertation. I also owe many thanks to Prof. Stefaan Van den Bogaert, Prof. Hans Gribnau, Prof. Kees van Raad and Prof. Frans Vanistendael for their membership of the Opposition Committee.

I would also like to thank my colleagues at the Institute of Tax Law and Economics at Leiden University. In particular, I would like to thank Prof. Allard Lubbers for being such a supportive friend during all these years. Special thanks must also go to Dr. Koos Boer. His humour and comradeship have been of great value to me.

I must also thank my colleagues at PwC in Rotterdam and Amsterdam for providing me with the opportunity to combine my work as a tax advisor with my academic work. Without their support this would not have been possible. In particular, I am grateful to Walter de Zeeuw, Diederik van Dommelen, Marc Diepstraten, Prof. Stef van Weeghel, Dr. Ruud Sommerhalder and Paul van Amersfoort. Special thanks should also go to my international colleagues in PwC's EU Direct Tax Group. The discussions during our bi-annual conferences have been a great inspiration. In particular, I would like to thank the members of the Technical Committee for our great and sometimes never-ending exchange of ideas on EU law: Edward Attard, Peter Cussons, Dr. Gitta Jorewitz, Prof. Jürgen Lüdicke, Bob van der Made, Dr. Emmanuel Raingeard de la Blétière, Dr. Nana Sumrada, Jacques Taquet and Caroline Wunderlich. I would also like to thank Anna Gunn for always sharpening my thoughts on matters of EU law. The same is true for my former colleague Pieter van der Vegt, who has played an important role in the development of my thoughts on EU free movement and State aid in the context of direct business taxation.

My most special thanks go to my friends and family, in particular to my parents, my parents-in-law, Anjeleen and Reimer, Maarten and Sanne, and Freek and Suzanne, for all their love and understanding. Above all, I would like to thank my wife Lara for always being there for me and our children Wytse, Nynke and Jelle, despite her own challenging career. We have done this together.

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[3] Pötgens 2006.

List of abbreviations

ECJ	Court of Justice of the European Union (per 1 December 2009) or Court of Justice of the European Communities (before 1 December 2009)
EC	Reference to a provision of the EC Treaty in its numbering after 1 May 1999
ECHR	European Convention on Human Rights (Convention for the Protection of Human Rights and Fundamental Freedoms)
ECtHR	European Court of Human Rights
EC Treaty	Treaty establishing the European Community If used as reference to a provision – e.g. Article 6 of the EC Treaty – it indicates the numbering before 1 May 1999
EEA	Agreement on the European Economic Area of 2 May 1992
EU	European Union If used as reference to a provision it indicates the numbering after 1 May 1999
FCC	German Federal Constitutional Court (Bundesverfassungsgericht)
ICCPR	International Covenant on Civil and Political Rights
OECD	Organisation for Economic Co-operation and Development
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
VCLT	Vienna Convention on the Law of Treaties (done at Vienna on 23 May 1969)

Part I:

Introduction

1. Scope, structure and purpose of this study

1.1 The conflict between tax sovereignty and free movement

Although, as EU law stands at present, direct taxation does not fall within the purview of the Union, the powers retained by the Member States must nevertheless be exercised consistently with EU law. This is the now classic statement of the ECJ in *Schumacker*.[4] This proposition very clearly reveals the conflict between two areas of legal competence of which the rules are more or less carved in stone.

On the one hand, it is settled ECJ case law that EU law takes precedence over national law and that it has direct effect if its provisions are clear, precise and unconditional enough to be invoked and relied upon by individuals before national courts. The TFEU's provisions of free movement of goods, persons, services and capital meet the criteria of direct effect,[5] so that any national tax measure which contravenes a free movement provision is rendered automatically inapplicable (the TFEU contains only a few possible exceptions[6] which are almost never applicable to national direct tax rules).

On the other hand, the Member States as a matter of principle retain extensive competences in tax matters. They remain free to determine the organization and conception of their tax system and to determine the need to allocate between themselves the power of taxation.[7] Apart from these 'internal' objectives, the Member States are also at liberty to pursue 'external' objectives through tax measures such as the protection of the environment or stimulation of research and development. Indeed, as Ghosh has stated, it is hard to conceive of a more sensitive area of domestic Member States' competence, either legally or politically, than direct taxation.[8]

The ECJ, called upon to interpret and apply the free movement provisions of the TFEU in direct taxation cases, has the difficult task of interpreting and applying the free movement provisions in relation to national direct tax measures. It seems obvious that a literal interpretation of the free movement provisions – without any further exceptions than the express Treaty derogations – would severely undermine the powers retained by

4 Case C-279/93 *Schumacker*, § 21.

5 E.g. Case 26/62 *Van Gend & Loos*.

6 Express Treaty derogations are laid down in Articles 36, 45(3), 52(1), 62 and 65(1)(b) TFEU and typically relate to reasons such as public policy, public health and public security.

7 Opinion AG Poiares Maduro in Case C-446/03 *Marks & Spencer*, § 23-24. See for a similar statement in the context of Article 107 TFEU (State aid) Joined Cases T-211/04 and T-215/04 *Government of Gibraltar v Commission*, § 46, and the Opinion of AG Jääskinen in Joined Cases C−106/09 P and C−107/09 P *Commission and Spain v Gibraltar and UK*, § 137 *et seq*.

8 Ghosh 2007, p iii.

the Member States in the field of direct taxation. In turn, not to apply the fundamental freedoms to direct taxation on the ground that the latter does not fall within the purview of EU law would deny the existence of the obligations to which the Member States have committed themselves when they concluded the TEU and the TFEU with the creation of an internal market as the primary objective. As a consequence, the ECJ has the difficult task of reconciling the consequences of the fiscal sovereignty retained by EU Member States with the obligations flowing from EU law (an internal market without frontiers). How should sovereign rights be reconciled with the obligations enshrined in the TEU and the TFEU?

1.2 A wide variety of criticism

The ECJ has been criticized on several points for the way it balances fiscal sovereignty against free movement. It has been accused of going too far in striking down national direct tax rules, thereby effectively failing to appreciate that the Member States have intended to retain their national tax sovereignty.[9] It has been accused of not understanding the difficult area of tax law.[10] Also, the ECJ has been blamed for acting as a legislator rather than as a court by positively harmonizing national tax law instead of only (negatively) reviewing national tax measures for compatibility with the fundamental freedoms.[11] Other authors have argued that the ECJ is fully competent to positively harmonize national tax laws and that it should use this power.[12] At the same time, especially in recent years, the ECJ has been blamed for giving the Member States too much leeway.[13] Apart from these

[9] Warren & Graetz are of the opinion that the ECJ is "undermining the fiscal autonomy of Member States by articulating an interpretation of income tax arrangements that is ultimately unstable"; see Graetz & Warren 2006, at p. 1188. Eric Kemmeren fears that the ECJ does not respect integrated tax systems anymore; Kemmeren 2008. Dennis Weber states that the ECJ case law is incorrect from a dogmatic point of view because the Court does not pay heed to the consequences of its own basic assumptions e.g. that the Member States are free to determine the criteria for taxation in order to delimit tax jurisdiction and to avoid double taxation and that "the ECJ does not always have sufficient respect for a Member State's tax jurisdiction"; see Weber 2007.

[10] E.g. Wattel has accused the ECJ of "bloopers" and "conceptual confusion, erroneous understanding of international tax law, or even incompatibility with EC Law itself"; see Wattel 2004, p. 81.

[11] Ghosh has argued that the ECJ sometimes requires Member States to extend their legislative tax jurisdiction, thereby positively integrating tax systems and overstepping its competence; see Ghosh 2007, p 81. Wattel has submitted that the ECJ wrongly applies a kind of 'always somewhere' principle which apparently positively requires that a taxpayer should be able to deduct negative items of his income somewhere in the Community; see Terra & Wattel 2008, p 350-351.

[12] E.g. Vanistendael is of the opinion that the ECJ is competent to prescribe that a Member State should employ a system of capital and labour-import neutrality (CLIN); see Vanistendael 2008, p 96.

[13] Kofler and Mason criticize the judgment in Case C-513/04 *Kerckhaert and Morres* in which the ECJ decided that international juridical double taxation does not breach the free movement provisions; they argue that this outcome is not acceptable in an internal market; see Kofler &

criticisms of the ECJ's alleged policy, many writers have argued that the ECJ applies the free movement provisions in the area of direct taxation inconsistently and unclearly. As a result, neither national legislators nor taxpayers would be able to tell which national tax measures are 'EU-proof' and which are not.[14]

Traditionally, the literature on this subject attempts to identify mistakes or missed opportunities by the ECJ by taking generally accepted principles of national and international tax law and existing ECJ case law as a starting point. In my view, this 'internal' approach cannot lead to a satisfactory answer to the question of whether the ECJ's case law is correct or incorrect with respect to the reconciliation of national direct tax sovereignty and free movement. As can be seen in the literature just mentioned, it results in an over-simplified discussion in which positions are taken which are often motivated only by referring to the position itself. For instance, the view that the ECJ has given a decision which goes against a Member State's tax sovereignty in an unacceptable way is often motivated by reference to the importance of sovereignty itself. That, however, is a *petitio principii*. As a consequence, the present tax literature does not provide for a structured approach through which it can be determined whether the ECJ has taken a 'right' decision and whether a fair balance has been struck in a particular case or not.

1.3 Towards a theoretical assessment model

It is submitted that a proper analysis can only be made in the light of an assessment model which is external to and independent of the ECJ's current case law. This model should, first, explain how the ECJ's case law in the area of free movement and direct taxation should be structured in theory. Secondly, the assessment model should be able to provide for a better description of ECJ case law than is currently available in literature. Thus, the assessment model should enable scholars to assess whether the decisions arrived at by the ECJ are well-founded or not. The assessment model should also be able to anticipate possible future developments in the case law.

1.4 Methodology

The present study is structured as follows. Chapter 2 discusses literature on the most controversial case law of the ECJ in the area of free movement and direct taxation. The purpose of the summary of the most outspoken views in literature is to facilitate the design of a theoretical assessment model which should be able to structure the case law and make a response to these views possible.

Part II of the present study designs such a model. As stated earlier, this model should be external to the ECJ's current case law. It will be explained in chapter 3 that it

Mason 2007, p 79-81. See for criticism on the judgment in Case C-376/03 *D*, in which case the ECJ found against the taxpayer, Van Thiel, who calls this decision "very unfortunate, mainly because its wider implications undermine very basic principles of Community law"; see Van Thiel 2005, p 457. Compare also Van Thiel 2002, p 486-525.

[14] According to Snell, for example, the use by the ECJ of the language of obstacles and restrictions in direct tax cases leads to "legal uncertainty and lack of predictability"; see Snell 2007, p 367.

is an internationally accepted method to understand, structure and assess the practice of courts around the world through external theories of law. Subsequently, chapter 3 gives an introduction to and account of the choice of the legal theory which may serve as a blueprint for a theoretical assessment model. The choice of the appropriate legal theory will be limited by the basic presumption in ECJ case law that although, as EU law stands at present, direct taxation does not fall within the purview of the Union, the powers retained by the Member States must nevertheless be exercised consistently with EU law. Another approach would lead to the design of an assessment model without any connection to the present stance of EU law. Chapters 4, 5, 6 examine to what extent the legal theory chosen in chapter 3 is applicable to the conflict between tax sovereignty and EU free movement. Chapter 7 subsequently provides a tailor-made theoretical assessment model which serves as a conceptual framework. In doing so, this study makes a normative claim as to how the conflict between free movement and tax sovereignty should be resolved in theory. It should be stressed that this study does not claim that the theoretical assessment model arrived at necessitates only one solution in an individual case. Rather, the model prescribes the method through which the problem should be solved, thus limiting the number of possible outcomes and structuring the analysis in a coherent manner.[15]

Part III of this study analyzes the ECJ's case law in the light of the assessment model developed in part II. It will be shown that the – sometimes implicit – approach followed in the vast majority of the case law can be explained and structured by the theoretical model. If the case law deviates from the model, an explanation for that will be provided, if possible. In addition, it will be shown that the theoretical assessment model predicts certain future developments in the case law which would at present be regarded as highly controversial. Thus, this study also makes a descriptive claim.

Part IV contains the conclusions of this study.

The approach taken in this book is new in the sense that it tests the ECJ's case law in the area of direct taxation against a theoretical assessment model. As a result, this study does not make extensive reference to the vast body of literature which exists in the area of direct taxation and free movement, apart from the following chapter's discussion of some of the most provocative and outspoken tax literature. The ECJ's case law and opinions of Advocate Generals with the ECJ will however be dealt with in detail. The aim of this study is not to give an overview of the *status quo*, but rather to examine the conflict between the competing principles of tax sovereignty and free movement from a different angle. Finally, this study covers a subject the title of which is very close to the recent and impressive study by Mathieu Isenbaert, *EC law and the Sovereignty of the Member States in Direct Taxation*, published as No. 19 of IBFD's doctoral series[16]. However, the approach taken in the present study is completely different from the approach in Isenbaert's thesis, because its objective is to develop an objective assessment model to optimize free movement and national sovereignty based on an established legal theory about the nature of and the relationship between principles and rules, whereas Isenbaert's study approaches the issue from the theory of constitutional pluralism and function-sovereignty. This is clearly

[15] Compare Von Bogdandy 2010, p 101.

[16] Isenbaert 2010.

demonstrated by some citations taken from his final observations.[17] The novelty of the theory of constitutional pluralism is the idea that the relationship between the State and the supra-State locus of authority should be perceived as heterarchical rather than hierarchical.[18] Further, the traditional meaning of 'sovereignty' as a *territorially exclusive* claim to ultimate authority can no longer be upheld in a heterarchical context.[19] The epistemic dimension of sovereignty can only be maintained by dividing the object of the ultimate claim to authority, the body politic, instead of the claim itself. In that respect, the concept of function-sovereignty has been proposed by Isenbaert, which implies that the dividing lines between the level of the Union and the level of the respective Member States, are based on the functions performed and the objectives pursued by those bodies.[20] Thus, constitutional pluralism entails that the EU constitutional structure can only be effectively analysed if one accepts that the two levels of sovereignty (or claims to ultimate authority) co-exist without a clear and generally applicable hierarchy as regards their respective entitlements to ultimate authority. In other words, the functions and objectives of the policy area over which the Member States have retained their sovereignty stand principally on an equal footing with the functions and objectives of the policy areas over which the EU has a sovereign claim.[21] This demonstrates the essential difference between Isenbaert's study and the present thesis: Isenbaert establishes the ultimate authority of the EU to intervene in matters of direct taxation on the basis of the core function to be performed by the EU level of authority – the establishment of the internal market – , taking into account the core function of the Member States, which is raising revenue. The present study's approach is to evaluate the ECJ case law in direct taxation on the basis of an assessment model which is not based on the constitutional relationship between the EU and the Member States, but which is rather derived from established legal theory which distinguishes between principles and rules. This theory examines what happens in case of a conflict between these different categories of norms. The confrontation between the principles of free movement and the principle of sovereignty should be decided, not on the basis of the core functions performed by the respective levels of government, but on the basis of an optimization process which consists of six subsequent stages (questions) described in this study.

17 Isenbaert, p 755-756, nrs. 1899-1902.
18 Isenbaert 2010, p 755, nr. 1899.
19 Isenbaert 2010, p 756, nr. 1900.
20 Isenbaert 2010, p 756, nr. 1901.
21 Isenbaert 2010, p 756, nr. 1902.

2. Severe criticism on the European Court of Justice in direct tax matters

2.1 Introduction

In direct taxation cases the ECJ generally uses the following model to assess whether a direct tax measure is a prohibited restriction on free movement (assuming that the taxpayer has "access"[22] to fundamental freedoms):

1. Does the direct tax measure constitute a restriction on free movement?
2. If so, does the direct tax measure pursue a legitimate objective which is compatible with the TEU and the TFEU and is it justified by overriding reasons in the public interest?
3. If so, does the application of the direct tax measure ensure achievement of the aim pursued?
4. If so, does the application of the direct tax measure not go beyond what is necessary for that purpose?[23]

The approach taken in three of the four steps in the ECJ's model in direct taxation cases has received considerable criticism. In this chapter a selection thereof will be discussed. The evaluation of this chapter will show that much of the criticism lacks a surrounding conceptual framework.

2.2 The concept of a 'restriction' on free movement in direct tax cases

2.2.1 Introduction

The first and most important criticism is directed at the (too) broad interpretation by the ECJ of the concept of a 'restriction' on free movement in direct tax cases. This wide scope of the free movement provisions undermines the tax sovereignty of the Member States in an unacceptable manner, according to various authors. In order to fully appreciate this criticism, it is important to explain first the direct tax jurisdiction of a State under

[22] Access meaning that the situation of the taxpayer falls within the personal, geographical and material scope of the TFEU's free movement provisions; see Kingston 2007, § 2.1, p 1323-1329. Compare e.g. Case C-112/91 *Werner*; Case C-492/04 *Lasertec*; Case C-102/05 *A and B*; Case C-157/05 *Holböck*; Case C-415/06 *Stahlwerk Ergste Westig*.

[23] E.g. Case C-527/06 *Renneberg*, § 81; Case C-446/03 *Marks & Spencer*, §35; Case C-196/04 *Cadbury Schweppes*, § 47.

international law and the inherent consequences of the co-existence of discrete national fiscal jurisdictions. Once this has been clarified, it will be discussed how the ECJ has dealt with these consequences under the EU free movement provisions and how this approach has been criticized.

2.2.2 The scope of a Member State's direct tax jurisdiction

Legislative jurisdiction under customary international law

The traditional approach of establishing jurisdiction is founded on the territorial and personal bases of jurisdiction. As Jeffery has demonstrated, the fundamental jurisdictional connection is the territorial basis that refers to jurisdiction over persons, matters and things within the geographical boundaries of a State.[24] In relation to fiscal jurisdiction, this is illustrated by the taxation of income with its source, or a person residing, within the territory.[25] The other jurisdictional connection is personal, based on the nationality or domicile of a person as the connecting factor.

Nationality is widely accepted as a valid jurisdictional basis for the assertion of a State's jurisdiction over persons. A person with the nationality of the taxing State can be liable to tax on his full, worldwide assets and income, from whatever source.[26] Consequently, a State has unlimited fiscal jurisdiction over its nationals. International law leaves it to a State to decide who are its nationals.[27] According to Jeffery, the incorporation of a company in a State is analogous to nationality with regard to persons, so that this is also a basis for unlimited fiscal jurisdiction.[28]

The principle of fiscal territoriality refers to jurisdiction over persons, matters and things within the geographical boundaries of a State. A State may tax a person residing in its territory or income arising there. The scope of jurisdiction of persons or income is by its nature different. A State has *unlimited fiscal jurisdiction* over individuals and companies *residing* within its territory. Consequently, a State is competent to tax the worldwide income of individuals and companies. Customary international law leaves it to States to determine who are their residents, including the nature and extent of presence within the territory that is required.[29] The concept of residence does, however, make it clear that a more permanent nature of contact is required to establish worldwide jurisdiction. As Martha has pointed out, fiscal jurisdiction on the basis of residence is, in the view of general international law, only relevant with regard to foreigners.[30] A State may tax non-resident aliens, individuals and companies, but only with regard to the particular sources of income within its territory. Accordingly, the fiscal jurisdiction of a State in respect of *non-resident aliens* is *limited* to the sources of income within the State.[31] Thus, the jurisdictional principle of fiscal territoriality includes unlimited fiscal jurisdiction with regard to resident aliens and limited fiscal jurisdiction in respect of non-resident aliens.

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24 Jeffery 1999, p. 44.
25 Compare Case C-451/99 *Cura Anlagen*, § 40.
26 Martha 1989, p. 48.
27 Jeffery 1999, p. 49. The ECJ respects this; see Case C-200/02 *Chen*, § 37.
28 Jeffery 1999, p. 49.
29 Jeffery 1999, p. 45.
30 Martha 1989, p. 50-51.
31 Martha 1989, p. 54.

The jurisdictional principles to tax referred to in the previous paragraphs may also be formulated negatively. A State may tax a foreign company with no headquarters in the State and carrying on business in the State on the income derived from that business, but not on its worldwide income. A State may also tax persons who are not nationals or residents of the State with regard to income derived from property in the State, but the property and income do not justify the taxation of property or income outside the State.[32] The American Law Institute has taken the position that the jurisdiction over tax nationals and residents implies that a State may tax a parent corporation on its worldwide income, including that of its branches and subsidiaries.[33]

Allocation of jurisdiction in tax treaties

It is clear from the outset that the application of these previously discussed rules of customary international law with regard to fiscal jurisdiction may lead to international juridical double taxation. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.[34] According to the Commentary to the OECD Model Tax Convention, the harmful effects on the exchange of goods and services and movements of capital and persons are so well known that it is unnecessary to stress the importance of removing the obstacles that double taxation presents for the development of economic relations between countries. The primary purpose of the OECD Model is to provide a way of settling, on a uniform basis, the most common problems in respect of international juridical double taxation. Most bilateral tax treaties are, to a large extent, based on the OECD Model. The OECD Model allocates the jurisdiction to tax and prescribes the method by which double taxation is eliminated.

Self-imposed unilateral limitations on jurisdiction

Many States have imposed unilateral limitations on the exercise of jurisdiction. For example, most States do not fully apply their worldwide jurisdiction on the basis of nationality.[35] With regard to the taxation of income, the Netherlands, for instance, only applies the personal basis for jurisdiction (the nationality of the taxpayer) to companies.[36] France operates a territorial system for corporate income tax purposes. In principle, account is only taken of profits realized in undertakings operating in France or in those liable to taxation in France by virtue of a tax treaty.[37] Consequently, France does not make use of its unlimited fiscal jurisdiction with regard to companies incorporated under French law

32 Restatement of the Law, Third, 1987, § 412(a).

33 Restatement of the Law, Third, 1987, § 412(e).

34 Commentary to the OECD Model, Introduction, § 1.

35 An exception is the United States, which, in principle, taxes its nationals on their worldwide income.

36 Although the principle of nationality also plays a minor role with regard to individuals, and in particular, in respect of diplomatic staff (Art. 2.2 of the Individual Income Tax Law (*Wet inkomstenbelasting* 2001)). For the worldwide jurisdiction with regard to companies incorporated under Netherlands law, see Art. 2(4) of the Corporate Income Tax Law (*Wet op de vennootschapsbelasting 1969*).

37 Art. 219 General Tax Code (*Code Général des Impôts* (*Territorialité de l'impôt sur les sociétés*)).

and those resident in France. Instead, France applies a strict territoriality principle for the taxation of company profits.

2.2.3 Consequences of the overlaps and limitations of direct tax jurisdiction

The co-existence of discrete national fiscal jurisdictions has various consequences. First, it leads to international juridical double taxation. After all, the application of the rules of customary international law with regard to fiscal jurisdiction – nationality, residence and source – leads to an overlap.

Secondly, disparities, or variations, will exist between these jurisdictions.

Thirdly, a State may treat situations that arise fully within its own jurisdiction differently from those that are only partly within its jurisdiction and partly in the jurisdiction of another State. If, for example, a French company opens a branch in Luxembourg, the losses attributable to the French head office will normally not be taken into account for determining the profits of the branch for Luxembourg corporation tax purposes, whereas the losses of a domestic head office would be deductible. The reason for this different treatment is that the French company – neither a national nor a resident of Luxembourg – is only subject to limited taxation in Luxembourg. Another example concerns a German company with income from industrial or commercial activities. Such a company is precluded, when calculating its profits, from deducting losses from a permanent establishment in another Member State on the ground that, according to the applicable tax treaty, the corresponding income from such a permanent establishment is not subject to taxation in Germany.[38]

Fourthly, a taxable subject or object may leave the tax jurisdiction. If a taxpayer owning assets with an unrealized gain leaves a State's tax jurisdiction or if these assets themselves leave the jurisdiction, that State will normally impose an exit tax on that unrealized gain. The reason for this is that the State concerned loses its jurisdiction to tax, as a result of which it considers it reasonable to tax the unrealized gains which have accrued on its territory.

2.2.4 ECJ case law on disparities, double taxation and discrimination

Now it has been established which consequences occur as a result of the co-existence of discrete national tax systems, it will be discussed how the ECJ has dealt with these consequences under the EU free movement provisions. Three categories can be distinguished: cross-border situations in which a disadvantage arises as a result of a disparity, international juridical double taxation, and discrimination.[39]

Disparities

A consequence of the co-existence of discrete national tax systems is that disparities, or variations, exist between these jurisdictions.[40] For example, a Member State may choose to

[38] These examples are inspired by Case C-250/95 *Futura* and C-414/06 *Lidl Belgium*.

[39] See for a more extensive discussion Douma 2006.

[40] See Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation,* § 43.

impose a relatively high tax rate within its jurisdiction. The existence of these disparities has inevitable distorting effects on investment, employment and, for companies and self-employed persons, establishment decisions. Possible distortions resulting from mere disparities between tax systems do not, however, fall within the scope of the free movement provisions in the TFEU. The ECJ has consistently held that the free movement provisions are not concerned with any disparities in treatment which may result, between Member States, from differences existing between the laws of the various Member States, so long as they affect all persons subject to them in accordance with objective, non-discriminatory criteria and without regard to their nationality.[41] Accordingly, it is clear that the obstacles resulting from disparities may be contrasted with obstacles resulting from discrimination, which occurs as a result of the rules of just one tax jurisdiction. It is important to note that the ECJ has accepted the power of the Member States to define, by tax treaty or unilaterally, the criteria for allocating their powers of taxation. If an allocation of jurisdiction to one of the Member States results in, for instance, a higher tax rate than a rate that would have applied in respect of an allocation of jurisdiction to another Member State, the resulting disadvantage is the outcome of a disparity and is not discrimination.[42]

International juridical double taxation
The impediments caused by international juridical double taxation are not the result of discriminatory treatment within one jurisdiction. Therefore, according to now settled ECJ case law, the adverse consequences of overlapping tax jurisdictions do not amount to *prima facie* restrictions on that ground.[43]

Discrimination: general remarks
According to the majority of scholars, a direct tax measure only constitutes a restriction on free movement if it treats a cross-border activity more harshly than a domestic activity: a discrimination approach.[44] Discriminatory treatment can consist both of different treatment of cases which are objectively the same, and of the same treatment of cases which are objectively different. This follows *inter alia* from the ECJ's consideration in the case of *Mertens*:

> "it is settled case law that there is unequal treatment when two categories of persons, whose factual and legal circumstances are not fundamentally different, are treated differently and when situations which are not comparable are treated in the same way".[45]

41 Case C-177/94 *Perfili*. See also Case 57/65 *Lütticke;* Case 61/79 *Denkavit italiana*, § 30-31; and Case C-427/05 *Porto Antico di Genova*, § 19-20.
42 Case C-336/96 *Gilly*. Compare also Case C-403/03 *Schempp*.
43 Case C-513/04 *Kerckhaert and Morres*; Case C-298/05 *Columbus Container Services*; Case C-67/08 *Block*; Case C-128/08 *Damseaux*.
44 Kingston 2007a, p 309
45 Case C-431/01 *Mertens*, § 32.

The same approach was taken by the ECJ in the cases of, for example, *Schumacker*[46] and *Kerckhaert & Morres*[47]. The question of whether two cases are in an objectively comparable situation must be answered in light of the object and purpose of the measure under consideration. This is clear from the ECJ's consideration in the case of *Papillon*:

> "In order to establish whether discrimination exists, the comparability of a Community situation with one which is purely domestic must be examined by taking into account the objective pursued by the national provisions at issue."[48]

A direct tax measure which does not lead to a disadvantage, either in law or in fact, for cross-border investment would in this view not constitute a restriction on free movement. If this were true, the application of the TFEU's free movement provisions to direct taxation would be different from other areas of law where national rules of a Member State which directly affect *access* to the market by reason of their objective or effects are regarded as restriction on free movement.[49] This approach focuses on the more general question of whether a national measure is liable to prohibit or otherwise impede access to the market or exercise of free movement.[50] In any event, the ECJ has so far not had the opportunity to deal expressly with this approach in direct taxation cases. The discrimination approach of the ECJ in direct taxation cases will now be discussed.

Discrimination on grounds of nationality

The classic four freedoms of the TFEU – free movement of goods, persons, services and capital – all prohibit distinctions which are directly based on the origin of the product or on the (foreign) nationality of the taxpayer concerned. Such distinctions can only be justified on grounds of the express Treaty derogations[51] such as public morality, public policy, public security and public health.[52] However, the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.[53] The criterion of 'residence' which is used by all national tax systems is such a criterion. As the ECJ explained in *Biehl*, even though the criterion of permanent residence in the national territory applies irrespective of the nationality of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who

46 Case C-279/93 *Schumacker*, § 30.

47 Case C-513/04 *Kerckhaert and Morres*, § 19.

48 Case C-418/07 *Société Papillon*, § 27. This approach is also apparent in Case C-231/05 *Oy AA*, § 38.

49 Opinion AG Tizzano in Case C-442/02 *CaixaBank France*, § 76.

50 See for example Case C-76/90 *Säger*, § 12; Case C-19/92 *Kraus*; Case C-55/94 *Gebhard*, § 37. An insightful discussion is provided by Snell 2010.

51 These are laid down in Articles 36, 45(3), 52(1), 62 and 65(1)(b) TFEU. Note that there are no treaty derogations for direct discrimination of goods on grounds of their origin as regards internal taxation of these goods (Article 110 TFEU).

52 Case C-423/98 *Albore*, § 16-17 and Case 2/74 *Reyners*.

53 Case 152/73 *Sotgiu*, § 11.

are nationals of other Member States.[54] A tax exemption based on the criterion that the company should employ at least five people in the territory of the Member State concerned is another example of a condition which unquestionably can be fulfilled more easily by 'national' companies than by 'foreign' companies, as a result of which this criterion leads to covert discrimination on grounds of nationality.[55] This broad formulation of indirect discrimination focuses on the *potential* effect on free movement.[56] Indirect discrimination on grounds of the origin or nationality of a product or person includes not only the different treatment of comparable situations, but also the equal treatment of comparable situations.

The case law in the field of direct taxation so far has mainly concerned the application of different rules to comparable situations.[57] *Prima facie* indirect discrimination on grounds of nationality in the area of direct taxation includes, for example, the application of withholding taxes only to non-resident taxpayers where resident taxpayers are not taxed on the income concerned,[58] the imposition of gross taxation on non-resident taxpayers and net income taxation on resident taxpayers,[59] the prevention of economic double taxation of dividends only with respect to resident shareholders,[60] the imposition of a higher effective income tax rate in respect of non-resident taxpayers,[61] legislation which lays down minimum tax bases only for non-resident taxpayers,[62] the non-availability of certain tax credits,[63] the imposition of rules which limit interest deduction only in respect of non-resident parent companies,[64] the refusal in respect of non-resident taxpayers to be able to deduct costs directly related to their source State income,[65] and the obligation for non-resident taxpayers to appoint a tax representative.[66]

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54 Case C-175/88 *Biehl*, § 14. See also Case C-151/94 *Commission v. Luxemburg* (*Biehl II)*.

55 Case C-464/05 *Geurts and Vogten*.

56 Barnard 2010, p 241.

57 Case C-431/01 *Mertens* is an exception.

58 Case C-290/04 Scorpio, § 33-34; Case C-282/07 *Truck Center*; Case C-303/07 *Aberdeen*; Case C-540/07 *Commission v Italy*.

59 Case C-234/01 *Gerritse*, § 28; Case C−345/04 *Centro Equestre da Lezíria Grande*, § 24. In Case C-105/08 *Commission v. Portugal* the ECJ could not answer the question of whether the application of a gross withholding tax to non-resident financial institutions constituted an infringement of freedom to provide services because the Commission had failed to provide adequate evidence.

60 Case 270/83 *Avoir fiscal*, § 16; Case C-307/97 *Saint-Gobain*, § 36-43; Case E-1/04 *Fokus Bank*, § 18-26; Case C-170/05 *Denkavit*, § 26-28; Case C-379/05 *Amurta*, § 27-28.

61 Case C-107/94 *Asscher*, § 45-49; Case C-433/06 *Hollmann*; Case C-43/07 *Arens-Sikken*; Case C-510/08 *Mattner*. Compare also Case C-562/07 *Commission v. Spain* and Case C-384/09 *Prunus*.

62 Case C-383/05 *Talotta*.

63 Case C-512/03 *Blanckaert*.

64 Case C-324/00 *Lankhorst-Hohorst*; Case C−524/04 *Test Claimants in the Thin Cap Group Litigation*; Case C-105/07 *Lammers & van Cleef*; Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation*; Case C-311/08 *SGI*.

65 Case C-234/01 *Gerritse*, § 28; Case C-265/04 *Bouanich*, § 35; Case C−345/04 *Centro Equestre da Lezíria Grande*, § 24; Case C-364/01 *Barbier*; Case C-11/07 *Eckelkamp*.

66 Case C-267/09 *Commission v Portugal*.

Discrimination against cross-border (economic) activity

The free movement provisions prohibit discrimination not only on grounds of nationality of the taxpayer but also on the basis of place of his (economic) activity. In *Daily Mail*, for example, the ECJ explained that even though the provisions on freedom of establishment are directed mainly towards ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation.[67] This is also true for the free movement of workers,[68] the freedom to provide services,[69] the free movement of capital,[70] and the freedom to move and reside within the territory of the Member States.[71] It should be noted that the free movement provisions not only prohibit the disadvantageous treatment of cross-border economic activity vis-à-vis domestic economic activity, but also the unilateral disadvantageous treatment of one cross-border economic activity vis-à-vis another cross-border economic activity.[72]

Prima facie discriminations on grounds of the place or destination of the (economic) activity in the area of direct taxation include, for example, the avoidance of economic double taxation on profits only for domestic investments,[73] exit taxation on unrealized gains in the case of 'emigration' of persons or assets,[74] the exclusion of relief for losses connected with a foreign permanent establishment,[75] a higher effective tax rate for cross-border investments,[76] non-recognition of foreign charitable entities for tax purposes,[77] non-deductibility of contributions to occupational pension schemes paid to insurance undertakings established abroad,[78] non-deductibility of fees for foreign schools,[79] the absence of tax credits for cross-border economic activity where they are available for

67 Case 81/87 *Daily Mail and General Trust plc*, § 16.

68 Case C-18/95 *Terhoeve*, § 37-39.

69 Case C-384/93 *Alpine Investments*, § 30.

70 Case C-370/05 *Festersen*, § 24.

71 Case C-520/04 *Turpeinen*, § 20. see further Case C-470/04 *N*, § 22; Case C-345/05 *Commission v. Portugal*, § 13; Case C-76/05 *Schwarz*, § 34.

72 See for the free movement of goods Case 13/63 *Commission v. Italy* (Italian refrigerators). For freedom of establishment see Case C-196/04 *Cadbury Schweppes*, § 45. For free movement of capital see C-194/06 *Orange European Smallcap Fund NV*, § 56.

73 Case C-251/98 *Baars*, § 30 *et seq.*; Case C-35/98 *Verkooijen*, § 34-36; Case C-319/02 *Manninen*, § 20-24; Case C-242/03 *Weidert & Paulus*, § 13-14; Case C-292/04 *Meilicke*, § 20-24; Case C-48/07 *Les Vergers du Vieux Tauves*, § 47; Case C-406/07 *Commission v. Greece*; Joined Cases C-439/07 and C-499/07 *KBC Bank*.

74 Case C-436/00 *X & Y*, Case C-9/02 *De Lasteyrie du Saillant*, Case C-268/03 *De Baeck*; Case C-470/04 *N*; Case C-345/05 *Commission v. Portugal*; Case C-104/06 *Commission v. Sweden*.

75 C-293/06 *Deutsche Shell*, § 29-32; Case C-414/06 *Lidl Belgium GmbH*.

76 Case C-334/02 *Commission. v. France* ('fixed levy'), § 23-25; Case C-315/02 *Lenz*, § 20-22; Case C-157/05 *Holböck*, § 24; Case C-436/06 *Grønfeldt*; Case C-256/06 *Jäger*; Case C-360/06 *Bauer*; Case C-377/07 *STEKO*; Case C-233/09 *Dijkman*; Case C-20/09 *Commission v. Portugal*.

77 Case C-386/04 *Stauffer*; Case C-318/07 *Persche*; Case C-25/10 *Heukelbach*.

78 Case C-522/04 *Commission v. Belgium*. Compare also Case C-544/07 *Rüffler*.

79 Case C-318/05 *Commission v. Germany*.

domestic activity,[80] the refusal of group taxation in cross-border situations,[81] the non-exemption of income from foreign lotteries,[82] and the application of anti-abuse legislation such as CFC-legislation or limitations on the deduction of interest payments only in cross-border situations or only in some cross-border situations and not in others.[83]

2.2.5 Criticism of the ECJ: reluctance to solve double taxation and failure to recognize 'dislocations'

The above-mentioned judgments in *Gilly* and *Schempp* – disadvantages as a result of disparities between national direct tax systems – have not been subject to much debate. They are widely accepted. The judgment in *Kerckhaert and Morres* – international juridical double taxation does not amount to a *prima facie* prohibited restriction on free movement – has however been received with some disapproval. The most outspoken critics of the ECJ in this regard are Kofler and Mason.[84] They have called this decision disappointing from an internal market perspective and subject to criticism on multiple levels. First, they contend that the ECJ could have applied its case law on 'double burdens'.[85] This case law means that measures which apply in law to both national and domestic products or services may in fact place a particular burden on imported goods or services. This different burden may arise because while the national producer or service provider has to satisfy only one regulator (the home State), the imported goods or services have to satisfy a dual regulatory burden (home State and host State regulation). According to Barnard, this is a more covert type of discrimination.[86] In the view of Kofler and Mason, the ECJ could have applied this case law to situations of international juridical double taxation, thereby effectively dividing tax jurisdiction between the Member States. Kofler and Mason further argue that the judgment in *Kerckhaert and Morres* leads to a non-symmetrical treatment of Member States vis-à-vis taxpayers: in prior cases the ECJ has decided that a taxpayer should not be able to offset tax losses in more than one Member State,[87] so why would the Member States, in turn, not be obliged to make sure that they tax a taxpayer only once on the same income? Finally, according to Kofler and Mason, the judgment in *Kerckhaert and Morres* rewards the inactivity of Member States, which – contrary to their obligation in

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80 Case C-254/*97Société Baxter*; Case C-39/04 *Laboratoires Fournier*; Case C-330/07 *Jobra*; Case C-287/10 *Tankreederei*.

81 Case C-264/96 *ICI*; Case C-200/98 *X AB & Y AB*; Case C-446/03 *Marks & Spencer*; Case C-418/07 *Société Papillon*; Case C-337/08 *X Holding*.

82 Case C-42/02 *Lindman*; Case C-153/08 *Commission v. Spain*.

83 Case C-196/04 *Cadbury Schweppes*, § 43-46; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*; Case C-311/08 *SGI*.

84 Kofler & Mason 2007, p 79-81. See for a critical analysis also Snell 2007, p 360 *et seq.*

85 This case law is based on the principle of mutual recognition. It means that products and services lawfully produced and put on the market in Member State A can and should be allowed access to the market of Member State B which can only restrict free movement on the basis of overriding reasons in the general interest. See Case 120/78 *Cassis de Dijon*, § 8 and Case 261/81 *Rau*, § 12.

86 Barnard 2010, p 92-93 and p 240-241.

87 E.g. Case C-446/03, *Marks & Spencer*.

Article 293 EC[88] – have not achieved or attempted to achieve comprehensive abolition of double taxation in the European Union by means of a multilateral tax treaty.

The second criticism of the ECJ is of an entirely different nature. This criticism relates to the refusal of the ECJ to distinguish the concept of 'dislocation' or 'fragmentation' of the tax base from the concepts of discrimination and disparity. The most prominent representative of this criticism is Wattel.[89] According to this author, the fourth category of 'dislocations' concerns cases in which a disadvantageous tax effect occurs because of a cross-border activity of a taxpayer, but one cannot say that one single jurisdiction (either the residence State or the source State) is to blame (therefore, no discrimination is afoot), and one cannot say either that the effect is caused by a disparity, since both States apply the same (but equally inconsistent) tax system. Thus, the disadvantageous tax effect is caused by the fact that the tax base (the income) falls within two tax jurisdictions, causing the need to divide that tax base between the two jurisdictions involved and to apply double tax relief mechanisms.[90]

Bosal,[91] *Manninen*[92] and *Marks & Spencer*[93] are three examples in which the distinguishing measure in question was defended by arguing that the disadvantageous treatment of the cross-border situation was caused by a jurisdictional mismatch. According to the Member States concerned, the national measures could not therefore be discrimination prohibited by EU law. The ECJ, however, did not share this view in any of these cases.

In *Bosal*, the ECJ held a Netherlands rule to be contrary to freedom of establishment. Under this rule, Netherlands resident parent companies could only deduct costs relating to the income from shares in a subsidiary if the subsidiary was taxable in the Netherlands or if its costs were indirectly instrumental in the making of profits taxable in the Netherlands.[94] According to AG Geelhoed, who was clearly influenced by Wattel's above-discussed writings, the ECJ has not accorded sufficient recognition to the Member States' division of tax jurisdiction in that case. He specifically refers to the finding of the ECJ that the comparability criterion is satisfied. It is, in AG Geelhoed's view, crucial to the analysis that the Netherlands exempted from taxation all 'inward' profits from non-domestic subsidiaries. According to the AG, the division of the tax jurisdiction between the Netherlands and the Member States of residence of the subsidiaries is such that jurisdiction to tax the foreign subsidiaries' profit fell solely on the source state. As a result, it appears to AG Geelhoed to be wholly consistent with this division of jurisdiction for the Netherlands to allocate those charges paid by the Netherlands parent that are attributable to the exempt profits of the foreign subsidiaries to the Member State of the subsidiaries. In AG Geelhoed's view, the position of a domestic parent company with a subsidiary whose profits are taxable in that Member State, on the one hand, and such a parent company with

88 Note that this provision has been repealed per 1 December 2009 (entry into force of the Treaty of Lisbon). See on this provision Raingeard de la Blétière 2008, p 91-105.

89 Wattel 2003, p 198 *et seq.*

90 Terra & Wattel 2008, p 48.

91 Case C-168/01 *Bosal Holding BV*, to a large extent confirmed in Case C-471/04 *Keller Holding*.

92 Case C-319/02 *Manninen*.

93 Case C-446/03, *Marks & Spencer*.

94 Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, § 62.

a subsidiary whose profits are not taxable (exempt) in that Member State, on the other, are not comparable. According to AG Geelhoed, *Bosal* is a classic example of a difference in treatment resulting directly from dislocation of tax base. The AG thinks that the result of the judgment is to override the Member States' choice of division of tax jurisdiction and priority of taxation. This choice, according to AG Geelhoed, lies solely within Member States' competence.

Manninen concerned Finnish legislation, whereby Finland granted a full imputation tax credit to Finnish shareholders in respect of Finnish corporate income tax levied on profits distributed as dividends. No tax credit in respect of foreign corporate income tax levied on foreign-source profits distributed as dividends was, however, granted. The ECJ held that Article 56 EC (free movement of capital; now Article 63 TFEU) required Finland to extend this tax credit to account for corporate income tax levied on dividends from another Member State - in this case, Sweden.[95] Wattel has, however, criticized the judgment in *Manninen*. In his view, domestic company profits may only be regarded as equal to company profits outside the jurisdiction if the existence of separate fiscal jurisdictions and jurisdictional mismatches is ignored. Wattel states that, if jurisdictional mismatches are ignored, fiscal sovereignty is also disregarded. He argues that the differential treatment is the result of a 'dislocation', i.e. a mismatch caused by exposure to more than one jurisdiction, and not of a discrimination or restriction within the scope of the EU law. He blames the ECJ for being a substitute legislator by prescribing which jurisdiction should remove the fiscal impediments caused by jurisdictional mismatches.[96]

The case of *Marks & Spencer* concerned the UK system of group relief that allows UK resident companies in a group to offset their profits and losses amongst themselves. This is not allowed for losses incurred by a group company established in another Member State which does not conduct any trading activities in the United Kingdom. The ECJ considered that this system of group relief is a restriction on the freedom of establishment (Article 49 TFEU), in that it applies different treatment for tax purposes to losses incurred by a resident subsidiary and losses incurred by a non-resident subsidiary. The ECJ rejected the idea that, with regard to a group relief system, resident subsidiaries and non-resident subsidiaries are not in comparable tax situations, because a company resident in another Member State is not located within the fiscal jurisdiction of the United Kingdom (as a result of which that State cannot tax the profits of the subsidiary). The ECJ, in effect, stated that the fact that the United Kingdom does not, in accordance with the principle of territoriality enshrined in international tax law and recognized by EU law, tax the profits of the non-resident subsidiaries of a parent company established on its territory, does not in itself justify restricting group relief to losses incurred by resident companies. The UK has to accept losses from a non-resident subsidiary if the possibilities of using the losses have been exhausted in the subsidiary's Member State and the UK parent company demonstrates this.

The position that jurisdictional arguments are not, by definition, decisive was confirmed by the ECJ judgment in the *N*-case.[97] The *N*-case concerned the Dutch taxation

[95] Opinion AG Geelhoed in Case C-446/04 *Test Claimants in the FII Group Litigation*, § 44.
[96] Peter Wattel, case note to Case C-319/02 *Manninen*, *BNB* 2004/401, § 11.
[97] Case C-470/04 *N*.

of latent increases in value of shares, the taxable event being the transfer of the residence of a taxpayer, with a 'substantial holding' in a company, outside the Netherlands. It was possible to benefit from suspension of payment until the disposal of the shares, subject to conditions, such as the provision of guarantees. In addition, decreases in value occurring after the transfer of residence were not taken into account in order to reduce the tax debt. The ECJ considered that the 'exit tax' at issue is in itself in accordance with the fiscal jurisdictional principle of territoriality. Nevertheless, the ECJ went on to examine whether such a measure goes beyond what is necessary to attain the objective it pursues. It concluded that in order to be regarded as proportionate to the objective pursued, such a system for recovering tax on the income from securities would have to take full account of reductions in value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State. One can recognize a parallel here with *Marks & Spencer*, since losses suffered outside a State's direct tax jurisdiction should be taken into account under certain conditions.[98]

Thus, the judgment in *N* makes it again perfectly clear that the circumstance of certain facts occurring outside a State's jurisdiction cannot in itself justify that such facts should fall outside the scope of comparison with a situation which does occur (fully) within a State's jurisdiction. This has been confirmed in the judgments in *Rewe Zentralfinanz,*[99] *Oy AA*,[100] *Lidl Belgium*[101] and *Renneberg*[102]. Weber has summarized the criticism of this line of reasoning as being incorrect from a dogmatic point of view because the ECJ does not pay heed to the consequences of its own basic assumptions, namely that the Member States are free to determine the criteria for taxation in order to delimit tax jurisdiction and to avoid double taxation. Moreover, the ECJ does not show sufficient respect for a Member State's tax jurisdiction; the *Marks & Spencer* judgment, for example, allegedly constitutes "a major breach of Member States' sovereignty".[103]

Thus, the ECJ is criticized from different angles. According to authors such as Kofler and Mason, the ECJ is too hesitant towards Member States which should have been compelled by it to eliminate international juridical double taxation. According to authors such as Wattel and Weber, however, the ECJ does not show sufficient respect for a Member State's

98 Case C-446/03, *Marks & Spencer,* § 55.

99 Case C-347/04 *Rewe Zentralfinanz*, § 43: "a difference in tax treatment between resident parent companies according to whether or not they have subsidiaries abroad cannot be justified merely by the fact that they have decided to carry on economic activities in another Member State, in which the State concerned cannot exercise its taxing powers. Accordingly, an argument based on the balanced allocation of the power to impose taxes between the Member States cannot in itself justify a Member State systematically refusing to grant a tax advantage to a resident parent company, on the ground that that company has developed a cross-border economic activity which does not have the immediate result of generating tax revenues for that State."

100 Case C-231/05 *Oy AA*: "the mere fact that parent companies which have their corporate establishment in another Member State are not subject to tax in Finland does not differentiate the subsidiaries of those parent companies from the subsidiaries of parent companies which have their establishment in Finland, and does not render the positions of those two categories of subsidiary incomparable".

101 Case C-414/06 *Lidl Belgium*.

102 Case C-527/06 *Renneberg*. See for severe criticism of this judgment Kemmeren 2009.

103 Weber 2007.

direct tax sovereignty. The authors however have in common that they criticize the ECJ from one viewpoint: the principle of free movement or the principle of tax sovereignty, either one of which would not have been given sufficient weight by the ECJ. A conceptual framework to determine whether the concrete decision in a certain case is correct or not is currently missing. Part II of the present study attempts to provide such a framework. First, however, some criticism on the second level of the ECJ's assessment model is reviewed.

2.3 Justification analysis in direct tax cases

It is settled ECJ case law that a restriction on free movement can be justified only if the restrictive measure pursues a 'legitimate aim compatible with the Treaty' and is 'justified by overriding reasons of public interest' (in the literature referred to as the 'rule of reason').[104] Four comments are made in respect of the discussion of these conditions in the literature.

First, most tax literature examines these requirements by making lists with 'actually accepted' grounds of justification, 'in principle accepted justifications, but never in practice' and 'rejected justifications'.[105]

Second, after having completed these lists, tax literature finds it difficult to explain why a certain ground of justification appears in one of these three lists and not in another. Mason, for example, finds it 'significant' that the ECJ has uniformly rejected justifications based on loss of tax revenue and the need to maintain the domestic tax base.[106]

Third, literature criticizes the way in which the ECJ interprets a ground of justification once it has been categorized in one of the lists. For example, an 'accepted' justification ground such as the need to maintain the cohesion of the tax system is examined as if such a justification were an autonomous object of interpretation. Vanistendael, for example, has analyzed the justification on grounds of cohesion in an article discussing how this justification has arisen as a phoenix from the ashes.[107] In *Verkooijen*, the ECJ allegedly held that the need to ensure the cohesion of a tax system may justify rules liable to restrict fundamental freedoms only if a direct link exists, in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which relate to the same tax.[108] In the above-discussed cases of *Manninen* and *Marks & Spencer* a "new principle of cohesion" would have been born in a "movement of cautious relaxation".[109] This is the common view among scholars.[110]

Fourth, tax literature criticizes the terms which the ECJ uses in referring to certain grounds of justification. The ECJ would wrongly suggest that some of these grounds should be regarded as separate justifications, where they would essentially reflect one and the same 'real' justification. According to Wattel, for example, the justification ground

104 E.g. Case C-360/06 *Heinrich Bauer Verlag*, § 34.
105 See for instance Roth 2008, p 79 and 94; Kingston 2007, p 1347.
106 Mason 2007, p 85.
107 Vanistendael 2005.
108 Case C-35/98 *Verkooijen*, § 56.
109 Vanistendael 2005.
110 E.g. Kingston 2007, p 1348-1349

of "[f]iscal coherence is really the fiscal territoriality principle".[111] Also, the 'principles' of coherence, territoriality and the allocation of taxing powers were basically the same thing: just another name for the same justification.[112] Another matter which has exercised many minds concerns the question of 'how many' justifications have to be present in order for a restriction on free movement to be justified. Should three justifications be present, or are two or even one enough?[113] Apart from this, Lang has argued that the ECJ should refrain from introducing 'new' grounds of justification, because they would lead to uncertainty.[114]

These four comments, although based on careful legal reasoning, show that tax literature is currently not capable of placing the ECJ's justification analysis in a conceptual framework which goes beyond the necessarily coincidental fact patterns of the case law and which is apt to clarify the choices which the ECJ has made and is making. As mentioned earlier, part II of the present study aims at providing such a conceptual framework. First, however, some criticism on the third level of the ECJ's assessment model needs to be reviewed.

2.4 Proportionality analysis in direct tax cases[115]

Once it has been established that a direct tax measure constitutes a restriction on free movement which can be justified by overriding reasons of general interest, a proportionality analysis needs to be performed. As stated in section 2.1 of this study, it should be examined i) whether the application of the direct tax measure ensures achievement of the aim pursued (suitability test), and ii) whether the application of the direct tax measure does not go beyond what is necessary for that purpose (necessity test). The suitability test is not controversial in tax literature. The necessity test, however, is subject to some criticism, in particular in cases where the ECJ might be accused of making political decisions in the framework of this test. Ghosh and Wattel are prominent critics of the ECJ when it comes to the performance of this test.[116]

The above-discussed judgment in *Marks & Spencer* can serve as an example.[117] To recapitulate, Marks and Spencer was a UK-based group with subsidiaries in several Member States. The continental European subsidiaries (in Belgium, France and Germany) ran into losses during the 1990s. UK resident Marks & Spencer plc sought to offset these losses against the profits derived in the United Kingdom. As the UK group relief system only allowed for the surrender of losses from UK resident companies or non-resident companies carrying on trade in the United Kingdom via a permanent establishment (PE), Marks & Spencer plc was denied the offset of the losses incurred in

111 Wattel 2004, p 92.
112 Wattel 2007 and Terra & Wattel 2008, p 373-374.
113 Isenbaert 2009, p 274.
114 ang 2009, p 113.
115 Reference is made to Emiliou 2006 and Jans et al. 2007, p 142 et seq. for an extensive discussion of proportionality analysis in ECJ case law in general. The present study will discuss the application of the principle of proportionality in direct taxation cases in detail in chapter 8.
116 Ghosh 2007, p 81 *et seq*; Terra & Wattel 2008, p 350-351.
117 See for further comments on this case Douma & Naumburg 2006.

the non-resident subsidiaries. As explained before, the ECJ decided that this constitutes a *prima facie* restriction on freedom of establishment. In deciding whether or not the UK restriction could be justified, the ECJ stated that it is necessary to analyze what the consequences would be if the domestic advantage, i.e. the loss surrender, were to be *extended unconditionally*.[118] This statement forms the basis for the subsequent analysis. In this framework, the ECJ considered three justification arguments. First, according to the ECJ, the need to preserve a balanced allocation of taxing powers between the Member States could make it necessary to apply to the economic activities of companies established in one of those Member States only the tax rules of that Member State for both profits and losses. Second, the ECJ accepted that Member States must be able to prevent losses from being used twice. A double use of losses would occur if the losses of a foreign subsidiary could be used both in the subsidiary's Member State and in the parent's. Third, the ECJ noted that there is a risk that losses will be transferred to companies established in the Member States which apply the highest rates of taxation. It held that "in the light of those three justifications taken together" the restriction in the UK system was justified. However, turning to proportionality analysis, the ECJ finally held that the preservation of a balanced allocation of taxing rights, the prevention of the double use of losses and tax avoidance could be attained by less restrictive measures. This was to accept losses from a non-resident subsidiary if the possibilities of using the losses had been exhausted in the subsidiary's Member State and the parent demonstrated this.

This performance of the necessity test has been criticized severely by Ghosh and Wattel. The ECJ would have no competence to decide under what circumstances a certain loss of a foreign subsidiary should be transplanted from one tax jurisdiction to another. Wattel has coined the term of 'the-always-somewhere-principle' which the ECJ allegedly observes in direct tax cases – a tax loss or deduction should be able to be deducted somewhere in the Union – but for which there would be no basis whatsoever in EU law.[119] Similarly, Ghosh has accused the ECJ of requiring that a Member State exercises tax jurisdiction where it has explicitly chosen not to do so: the foreign subsidiaries of Marks & Spencer were fully outside the UK's tax jurisdiction. To require that a tax loss of these subsidiaries should under the circumstances be transferred to the UK nevertheless amounts to *positive* integration by the ECJ, according to Ghosh. The ECJ – being a court and not a legislator – would not be competent to formulate positive legislation under the guise of the fundamental freedoms.[120]

2.5 Conclusion

The criticism discussed in sections 2.2, 2.3 and 2.4 shows that tax literature is wrestling with the reconciliation of tax sovereignty and free movement. Wattel has called this a "struggle between the two in principle irreconcilable positions of allowing Member States to protect their taxing jurisdictions as defined by them, and at the same time prohibiting

[118] Case C-446/03 *Marks & Spencer*, § 41.

[119] Opinion AG Wattel before HR 22 December 2006, No. 39258, BNB 2007/134, § 3.2; Terra & Wattel 2008, p 350-351.

[120] Ghosh 2007, p 93-94.

them to tax cross-border positions less favourably than comparable domestic positions." Accordingly, the "key question is where the right balance lies between free movement rights and tax share protection."[121] The above analysis has shown that tax literature is currently unable to explain why the ECJ does not distinguish dislocations from 'real' restrictions, why international juridical double taxation does not lead to a restriction on free movement, why certain justifications are rejected in some cases and accepted in others and on which grounds the ECJ performs a balancing test like the one in *Marks & Spencer*. The ECJ would fail to recognize that EU Member States have retained their sovereignty in the field of direct taxation, it would wrongly harmonize direct taxation by formulating positive rules and it would 'invent' new grounds of justification or 're-invent' grounds once rejected. The current literature attempts to explain this by taking existing ECJ case law as a starting point or by emphasizing the importance of either tax sovereignty or free movement. As appears from the discussion above, however, this 'internal' approach cannot lead to a satisfactory answer to the question of whether the approach taken in ECJ case law is correct or incorrect with respect to the reconciliation of national direct tax sovereignty and free movement. As can be seen in the literature just mentioned, it results in a politicized 'tis-'tisn't argument without bringing the discussion to a level where it can be objectively determined whether the ECJ has taken a 'right' approach in rendering its decision or not.

It is submitted that a proper analysis can only be made in the light of an assessment model which is external to and independent of the ECJ's current case law. This model should recognize that free movement and national direct tax sovereignty are fundamentally equal principles. One cannot say that free movement always prevails over national direct tax sovereignty. Nor can one say that national direct tax sovereignty always prevails over free movement. A theoretical assessment model which places the ECJ's case law on direct taxation in a conceptual framework will be designed in Part II of the present study.

[121] Terra and Wattel 2008, p 343-344.

Part II:

The Theoretical Optimization Model

3. Introduction and account of the choice of the model

Part II designs a theoretical assessment model which places the ECJ's case law on direct taxation in a conceptual framework which is currently missing in the literature. As stated in earlier, this model should be external to current case law. Such an approach – a method to understand, structure, explain and assess the practice of courts through external theories of law – is widely used and accepted. Dworkin, for example, has designed a normative theory of adjudication, which emphasizes the distinction between arguments of principle and policy. This theory defends the claim that judicial decisions based on arguments of principle are compatible with democratic principles. Subsequently, Dworkin has applied this normative theory to the central and politically controversial cases of constitutional adjudication. This made it possible to criticize the debate between judicial activism and restraint in constitutional law.[122] Other authors have specifically used general theories of law to understand and structure ECJ case law. Bengoetxea, for example, has applied insights derived from general legal theory to ECJ case law practice.[123] The more recent doctoral thesis by Conway examines the theory of conflict of norms in order to provide conceptual insight into justification and the role of value choices in ECJ legal reasoning. His thesis seeks to present an account, both descriptive and normative, of norm conflict resolution in EU law and the legal reasoning of the ECJ.[124] Harbo has discussed the work of *inter alia* Dworkin, Hart, Rawls, Raz, Habermas and Alexy to understand and structure the function of the proportionality principle in EU law.[125] And there are many others who have used insights from general theories of law to structure and assess ECJ case law.[126]

The question arises as to whether there is a model available in studies on legal theory which may serve as an inspiration for understanding and structuring the conflict between tax sovereignty and EU free movement.[127] This model should recognize that the Member States have retained their sovereignty in direct tax matters. In the absence of European harmonization, the ECJ is not competent to interfere in the conception or organization of the tax systems of the Member States.[128] On the other hand, under Union law, fiscal

122 Dworkin 1977, p xii.
123 Bengoetxea 1993.
124 Conway 2010.
125 Harbo 2010.
126 E.g. Paunio 2009 has drawn from Habermas' discourse theory of law, to discuss how the principle of legal certainty may be conceptualized within the context of EU law from the viewpoint of ECJ legal reasoning; Weyland 2002 has used Kelsen's theory of the legal system to answer the question how conflicts between EU and national constitutional norms should be resolved.
127 Compare for a similar search for a theory of judicial argumentation Bäcker 2008, p 26 *et seq*.
128 Opinion AG Poiares Maduro in Case C-446/03 *Marks & Spencer*, § 60.

sovereignty cannot be construed as meaning 'fiscal autarchy'. By subscribing to the TEU and the TFEU, the Member States agreed to submit to the regime of free movement within the Union. As AG Poiares Maduro has explained, that regime specifically requires the Member States to take account of transnational situations when applying their tax rules and to adapt those rules accordingly.[129] This proposition – one cannot say that free movement always prevails over national direct tax sovereignty nor that national direct tax sovereignty always prevails over free movement – means that both the EU free movement provisions and national tax sovereignty should be seen as relative 'principles' rather than absolute 'rules' (chapter 4 explains this widely accepted distinction between rules and principles in detail). Therefore, theories which regard some principles as being absolute – instead of relative – cannot serve as an inspiration for the development of a theoretical optimization model. For instance, Nozick's refusal to accept that claims of need can sometimes outweigh claims to property – that is taxation in a welfare State – is no inspiration for the present study because it makes an absolute political choice between two competing principles.[130] Nozick's strong defence of free-market libertarianism cannot be used in order to develop our theoretical assessment model, because neither the TEU nor the TFEU contains any explicit choice for a particular economic order.[131] For the same reason, Rawls' defence of egalitarian liberalism cannot serve as a direction for the ECJ.[132] Also, legal theories which are based on legal positivism cannot provide much guidance for the present study, because both national direct tax sovereignty and free movement cannot be regarded as positive rules. Positivism is a model of and for a system of rules.[133] These rules, however, are missing in the area which concerns the present study. A theory is needed which regards national direct tax sovereignty and free movement as *prima facie* reasons or principles and which provides a framework for reconciling these principles. This framework should be designed in such a way that no principle would always trump the other, which means that these principles should be given a very wide scope. After all, if one would narrow the scope of one of the principles in advance, this would essentially result in one principle always trumping the other in conflict situations which are outside the scope of the pre-limited principle.

For this reason, the present study will also not use Maduro's much-praised account of Article 34 TFEU (free movement of goods: prohibition of quantitative restrictions on imports and all measures having an equivalent effect; before 1 December 2009: Article 28 EC).[134] The model developed by Maduro seeks to take into account problems of legitimacy by limiting the scope of Article 34 TFEU. Problems of legitimacy arise because national measures which regulate the free movement of goods may affect interests which have not been represented in the – national – democratic legislative process. Similarly, decisions of the ECJ on the validity of such measures may imply playing a legislative role without democratic legitimization. Maduro has also argued that EU law does not direct the ECJ to

[129] Opinion AG Poiares Maduro in Case C-446/03 *Marks & Spencer*, § 62.
[130] Nozick 1974, p 30-31.
[131] Compare Ossenbühl 2000, p 561, for a similar statement with respect to the German constitution.
[132] Rawls 1971.
[133] Dworkin 1977, p 22.
[134] Maduro 1998.

review the degree of public intervention in the market and that "hidden" uniformisation of national regulations through Article 34 TFEU should be prevented. At the same time, according to Maduro, it is clear that an interpretation which only prohibits protectionist measures is insufficient in the present stage of European integration. All decisions concerning the common market should take all affected interests into account. Maduro suggests that the ECJ "should not second-guess national policy choices, but should instead ensure that there is no under-representation of the interests of nationals of other Member States in the national political process." In order to design a test to identify suspect measures, Maduro distinguishes between two types of interests affected by national measures which interfere with the free movement of goods: cross-national interests (uniform throughout the Union) and national interests (diverging throughout the Union). National measures which regulate market circumstances often regulate uniform interests: the way in which goods are, for example, sold on the market. In this case there is no danger of an over-representation of national interests or an under-representation of foreign interests. Rules on the characteristics of products do, however, tend to lead to under- or over-representation, because they may relate to typically national production habits. In short, if a national measure regulates uniform or cross-national interests it will not *prima facie* fall under Article 34 TFEU. The aim of this approach is that the ECJ will only review national measures if there is reason to fear for a representative malfunction in the national political process with regard to nationals of other Member States.[135] Thus, Maduro tries to reconcile three principles – free movement of goods, national sovereignty and democratic legitimacy – by a definition of the scope of Article 34 TFEU. Such an approach essentially means that it is defined *in advance* in which situations one of the principles always trumps another: by limiting the scope of a free movement principle, proportionality analysis is excluded in situations which fall outside the scope. In my view, this is an unnecessarily blunt result, whereas a more fine-tuned model should be possible by giving the principles their widest possible scope, after which it is examined to what extent all principles can be realized. This is perfectly possible in Maduro's model, which focuses on the interests recognized in the national political process and thus on the objectives of the national measure at stake. It should be possible to examine to what extent these objectives, which should indeed not be second-guessed from a legitimacy point of view, are realized in a way which is the least burdensome for free movement.

Alexy's theory of principles, which is closely related to Dworkin's rights theory, regards all principles as being relative.[136] Importantly, Alexy's theory of principles differs from Dworkin's rights theory, where Dworkin distinguishes principles from policies. According to Dworkin, a policy is a "kind of standard that sets out a goal to be reached, generally an improvement in some economic, political or social feature of the community (though some goals are negative, in that they stipulate that some present feature is to be protected from adverse change)." Conversely, a principle is "a standard that is to be observed, not because it will advance or secure an economic, political or social situation deemed desirable, but because it is a requirement of justice or fairness or some other dimension of morality."[137]

135 Maduro 1998, p 173-174.
136 Alexy 2002 and Dworkin 1977.
137 Dworkin 1977, p 22.

In Dworkin's theory, the term 'principles' points towards individual rights which are designed to safeguard the rights of the individual vis-à-vis the community. Rights are clearly more important than policies, because a right of an individual can only be limited by competing rights of other individuals and not by policies.[138] This is problematic for the present study, because the rights which individuals derive from the EU free movement provisions should not automatically trump the policies which Member States pursue through their tax systems. If that were to be the case, national tax sovereignty would in fact be denied. The present study will, therefore, not use Dworkin's rights theory. Instead, Alexy's theory of principles will be used for the development of a theoretical model for the optimization of national direct tax sovereignty and free movement. This theory does not juxtapose principles and policies. It does, however, distinguish rules from principles by examining what happens in the case of a conflict between those norms. If two rules conflict with each other, the solution will be to disapply one of the rules. If two principles collide, however, the solution is not found by disapplying one of the principles, but by realizing both of them within what is factually and legally possible. Contrary to rules, principles are not definitive but only *prima facie* requirements. They typically lack the resources to determine their own extent, which should be assessed in the light of competing principles and what is factually possible.[139] Thus, principles are optimization requirements. Their extent can be determined only in confrontation with another principle in the framework of an optimization model.[140]

This idea of the optimization of colliding principles perfectly fits the conflict between direct tax sovereignty and free movement. Sovereignty is to be framed as a principle and not as a rule in international law.[141] The principle of sovereignty – a *prima facie* general freedom of action of States, as limited by international law[142] – requires that its corollaries are realized within what is legally and factually possible. The extent of sovereignty, which can never be absolute, can be determined only in confrontation with other principles and rules. This confrontation can never lead to the disapplication of competing principles as such, but leads to the optimization of all interests involved under Alexy's theory of principles.[143] An example may clarify this. Weber has defended the position that a Member State should be able to exclude losses suffered by a foreign permanent establishment from the taxable basis of a resident company. This disadvantage should be *outside the scope* of the free movement provisions, because it follows directly from the sovereign right of a Member State to delimit its tax jurisdiction as it sees fit.[144] Thus, in Weber's view, the principle of sovereignty is in some cases absolute or, in other words, a rule. This view disregards the

138 Dworkin 1977, p 194.

139 Alexy 2002, p 57.

140 This does not mean that Alexy's theory is free of criticism; see for example Sieckmann 2009, p 42-43. In the view of the present author, however, Alexy's theory is the best theory available for purposes of solving the conflict between the *principles* of tax sovereignty and free movement.

141 Noll 1997, p 440. Verschuuren has also shown that sovereignty should be seen as a principle and not as a rule; see Verschuuren 2006, p 39. This point is further developed in chapter 5 of the present study.

142 Bernhardt 1985, p. 410.

143 Noll 1997, p 339-441.

144 Weber 2006, p 594.

fact that sovereignty cannot be understood as an absolute notion. The same applies to the principle of free movement in the EU's internal market. This principle *prima facie* protects a general freedom of (economic) action of persons. The extent of the principle of free movement can only be determined in confrontation with competing rules and principles. If it were otherwise, and its extent were unlimited, it would *de facto* deny that there is such a thing as sovereignty of Member States: it would prohibit taxation as such because taxation is undoubtedly an obstacle to free movement. Again, this confrontation between the two principles cannot lead to the disapplication of tax sovereignty, but the extent of the principle free movement should be determined through an optimization process. After all, both principles are of a fundamental equal weight.[145] It should be stressed that the notions of precedence and direct effect of EU law[146] do not mean that free movement should always set aside the principle of tax sovereignty. This is only the case *after* it has been assessed that a certain direct tax measure is indeed contrary to a free movement provision. This assessment is the object of the present study.

Alexy's theory has been criticized by many authors,[147] the most prominent of whom is Habermas.[148] Habermas is mainly concerned about two things.[149] Firstly, the idea that principles should be optimized in view of competing principles without any pre-determined outcome makes a goal-oriented weighting necessary. This means that individual rights could be sacrificed for the benefit of collective goals. This would rob constitutional rights of their strict priority over other considerations (policy arguments). The 'fire wall' between the protection of constitutional rights and the pursuit of public policy would collapse. Secondly, there would be no rational standards for balancing. This would open the door for arbitrary and unverifiable results. In my view, the objections brought forward by Habermas do not render Alexy's theory any less suitable for the purposes of the present study. After all, this purpose is to design a theoretical assessment model which meets the fundamental starting point in ECJ case law that EU Member States have retained their sovereignty in the area of direct taxation but that they should nevertheless exercise that competence consistently with EU law. This means that the policy goals pursued by

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145 Compare Maduro 2003, p 532: "any legal order (national or European) must respect the identity of the other legal orders; its identity must not be affirmed in a manner that either challenges the identity of the other legal orders or the pluralist conception of the European legal order itself". Pluralism means that no formal hierarchy exists among the applicable legal orders (Komárek 2007, p 30). In other words, both legal orders should respect each other competence. Compare Gerards 2011 who argues "that good use of the instrument of deference might help the EU courts to deal with the situation of pluralism that is currently visible in the European legal order. By means of deferential judicial review, the EU courts can pay due respect to national constitutional traditions and to national legislative and policy choices, thus preventing situations of real conflict. In addition, deference enables the EU courts to take into account the intricacies related to judicial review of norms drafted by co-equal institutions or by national elected bodies." See also Isenbaert 2010, p 226-227.

146 E.g. Case 26/62 *Van Gend & Loos*; Case 6/64 *Costa/ENEL*; Case 106/77 *Simmenthal III*.

147 Reference is made to Sieckmann 2009, Pavlakos 2007, Clérico & Sieckmann 2009 and Bäcker 2008.

148 Habermas 1996, p 254 et seq.

149 Compare Greer 2004, p 414, and Alexy 2002, p 388-389.

tax systems do not *a priori* have less weight that the principles of EU free movement.[150] With regard to the second objection brought forward by Habermas it must be admitted that there is a certain degree of arbitrariness to balancing. Alexy, however, has argued extensively that the balancing process does take place, to a large extent, in a rational and logical manner.[151] This will be dealt with more extensively in chapter 4.

Two other alternatives to Alexy's theory should be discussed. The first alternative is reflected by Hesse's notion of *praktische Konkordanz* (practical concordance).[152] This notion should be understood against the German idea of the unity of the community and the constitution. The notion of *praktische Konkordanz* has been accepted by the German constitutional court. It implies that all rights protected by the German constitution should be achieved as much as possible in individual cases: the right solution to a collision of norms is the decision where all of the competing principles and interests protected by them gain. An open question is to what extent *praktische Konkordanz* can be applied to constitutional rights which are accompanied by a limitation clause. The second alternative is reflected by the notion of *categorizations*.[153] When using this method a court gives clear general guidance on the application and interpretation of fundamental rights in certain categories of cases instead of engaging in a balancing exercise in individual cases. This leads to a higher degree of legal certainty. In my view, both alternatives are useful for the present study. They do not conflict with Alexy's theory, at least not in a way which would be harmful to the present study. Indeed, the notion of *praktische Konkordanz* sees fundamental rights as norms which should be optimized. This study will use Alexy's theory in order to give a more precise and dogmatic meaning to the process of optimization. This process may indeed result in specific 'rules' for certain categories of cases, which we will see in chapter 4.

I was certainly not the first to link Alexy's theory to the conflict between national sovereignty and free movement. Although no link has been established in literature between this theory and the direct taxation case law of the ECJ, Borgmann-Prebil, for example, has been a strong defender of applying Alexy's theory to the conflict in general. He states that the advantage of Alexy's approach lies in the fact that it employs the mechanism of balancing of principles for the settlement of conflicts between individual rights and the public good, as well as between conflicting public interests. Consequently, it may also serve as a doctrinal tool for the balancing of Member States' interests against Union interests, as is necessary in the application of the rule of reason. In this regard Borgmann-Prebil finds Alexy's notion of 'optimization precepts' particularly useful, because it dispels any sense of a conceptual hierarchy between the free movement provisions and the derogation grounds.[154] Also according to Moral Soriano, the ECJ has in fact included the theory of principles as commands to optimize in its model of legal reasoning.[155] Recourse

[150] Compare Harbo 2010, p 169.
[151] Alexy 2002, p 401 et seq.
[152] Hesse 1999, p 28.
[153] See Gerards & Bomhoff 2007 with reference to an extensive body of literature.
[154] Borgmann-Prebil 2008, p 340-341. This idea may seem to be at odds with ECJ case law stating that derogation or justification grounds should be interpreted narrowly (Barnard 2010, p 480). In practice, however, there does not seem to be significant difference (see section 4.4).
[155] Moral Soriano 2003, p 316. See also Pontier & Burg 2003, p 14-15.

to Dworkin's and Alexy's rights theories, and in particular Alexy's conception of rights as *prima facie* entitlements or 'optimization precepts', helps to assess the optimum between national sovereignty and free movement.[156] Bengoetxea, MacCormick and Moral Soriano have argued that the ECJ should not formulate a systematic order of principles, but should rather promote all of them (demand of proportionality). According to these authors, the ECJ understands proportionality in Alexy's sense: as a command to optimize - that is, as a command to find an equilibrium among all colliding interests and values.[157] Andenas and Zleptnig have reached similar conclusions with respect to WTO law.[158] It is the aim of part II of the present study to take these observations one step further and to formulate a theoretical optimization model on the basis of Alexy's theory which can be applied in direct tax cases. Subsequently, part III will examine to what extent ECJ case law reflects this theoretical model. In addition, it will discuss future developments in ECJ case law which can be expected on the basis of the theoretical model.

Chapter 4, which follows here, will analyze Alexy's theory on the optimization of competing principles. This will show how a conflict between competing principles should be resolved in theory. Subsequently, the *prima facie* meaning of the two competing principles at issue should be defined more precisely. The principle of direct tax sovereignty will be restated in chapter 5. The principle of freedom of movement in the EU's internal market will be outlined in chapter 6. The results of chapters 4, 5 and 6 will be used for the development of a theoretical optimization model for direct tax cases in chapter 7.

156 Borgmann-Prebil 2008, p 341.
157 Bengoetxea, MacCormick & Moral Soriano 2001, p 76.
158 Andenas & Zleptnig 2007, p 376-379.

4. Optimization of competing principles

4.1 A theory of principles: introduction

Robert Alexy's *A Theory of Constitutional Rights*' central thesis is that rights are principles and that principles are optimization requirements.[159] As such, they are open to balancing and proportionality analysis. This highly original idea has been praised as one of the most penetrating, analytically refined, and influential general accounts of constitutional rights available.[160] Although Alexy has written his work in a German constitutional context, the argument he makes is of universal application.[161] This chapter will summarize Alexy's theory so that it can be applied to the competing principles of national direct tax sovereignty and free movement in chapter 7, after they have been restated in chapters 5 and 6. For a thorough understanding of the theoretical optimization model in chapter 7 it is recommended to read chapters 4, 5 and 6 in advance. Chapter 7 does, however, contain cross-references to the other chapters so that it can also be read independently; occasionally the reader will have to thumb back to earlier sections as indicated. By definition, a summary of a theory as elaborate and refined as Alexy's theory is bound to be incomplete and too short to do justice to it fully. For the purposes of the present study, however, I believe the account given below should be sufficient.

Section 4.2 describes how rules and principles should be distinguished. This is important, because only principles are optimization requirements and it will be argued later that both national tax sovereignty and free movement are principles (sections 5.1 and 6.1). It will be argued in section 4.3 that the nature of a principle as an optimization requirement implies that its widest possible scope is adopted in order to be optimized in relation to competing principles. Section 4.4 shows that any competing principle may limit the application of a principle. This is important, because current ECJ case law requires that only 'compelling' or 'overriding' reasons in the general interest can serve as a limit. The optimization of competing principles is operationalised in section 4.5 through proportionality analysis. Notably, section 4.5.2 infers from Alexy's theory that a 'respectful aims' test should be introduced, although this test is not formally part of

159 Alexy 1985 and Alexy 2002.

160 Kumm 2004, p 574-575.

161 See also Alexy 2009, p 6: "The principle of proportionality consists of three sub-principles: the principles of suitability, of necessity, and of proportionality in the narrow sense. All three principles express the idea of optimization. To apply the principle of proportionality to constitutional rights means to treat them as optimization requirements, that is, as principles. For that reason, the term "principle" in what follows will often be used instead of the term "right"." See also Alexy 2009a.

Alexy's work. This test is pivotal to the argument made in the present study and evolves around the idea of a twofold neutrality between tax sovereignty and free movement. It will be argued in section 4.6 that the general public international law principle of good faith is not essentially different from Alexy's theory in the way in which conflicts are resolved on an international level. This is important, because the conflict which is central to this study is ultimately decided by an international court which is bound to apply the principle of good faith. Section 4.7 contains the conclusions of this chapter.

4.2 A distinction between rules and principles

It is crucial for a proper understanding of the theory of principles that norms should be divided into rules and principles. In respect of rules, Hart has made a distinction between primary rules and secondary rules.[162] Primary rules are rules of obligation ("drive on the right side of the road"). Secondary rules specify how to identify a rule as being part of the system (rules of recognition), how to change a rule (rules of change) and how to apply a rule (rules of adjudication).[163] Thus, law is mainly understood as a system of rules. Law, however, does not only consist of rules but also of principles. Hart's legal positivism has been criticized in this respect by Dworkin, who has emphasized the importance of principles in the law.[164] Dworkin has made a distinction between rules on the one hand and principles and policies on the other. A policy is a "kind of standard that sets out a goal to be reached, generally an improvement in some economic, political or social feature of the community (though some goals are negative, in that they stipulate that some present feature is to be protected from adverse change)." A principle is "a standard that is to be observed, not because it will advance or secure an economic, political or social situation deemed desirable, but because it is a requirement of justice or fairness or some other dimension of morality."[165] Principles include, for instance, the right to free speech or the right not to be discriminated against. According to Dworkin, the difference between legal principles (and policies) and legal rules is a logical distinction: "Both sets of standards point to particular decisions about legal obligation in particular circumstances, but they differ in the character of the direction they give. Rules are applicable in an all-or-nothing fashion. If the facts a rule stipulates are given, then either the rule is valid, in which case the answer it supplies must be accepted, or it is not, in which case it contributes nothing to the decision."[166] Contrary to a rule, a principle does not set out conditions that make its application necessary. "Rather, it states a reason that argues in one direction, but does not necessitate a particular decision."[167] Rules do, but Dworkin acknowledges that a rule may have exceptions. An accurate statement of the law would take this exception into account. Without the appropriate exceptions – even if there are theoretically many – a rule would, strictly speaking, be incomplete. In theory, all exceptions to a rule could be listed; the more

[162] Hart 1994, p 91-99.
[163] Summary by Taekema 2000, p 10.
[164] Gribnau 1998, p 49 et seq.
[165] Dworkin 1977, p 22.
[166] Dworkin 1977, p 24.
[167] Dworkin 1977, p 26.

of them there are, the more accurate is the statement of the rule.[168] A complete statement of a principle, however, would not be possible. The situations in which the application of a principle would be limited by 'counter-instances' could not be enumerated.[169] Thus, Dworkin's distinction between rules and principles is essentially based on the argument that rules apply in an all-or-nothing fashion, whereas principles do not because they have a dimension of weight. The 'closed' character of rules as opposed to the 'open' character of principles becomes apparent in the case of competing principles and conflicts of rules. According to Dworkin, one who must resolve the conflict between intersecting principles has to take into account the relative weight of each. If two rules conflict, one of them cannot be a valid rule. "The decision as to which is valid, and which must be abandoned or recast, must be made by appealing to considerations beyond the rules themselves. A legal system might regulate such conflicts by other rules, which prefer the rule enacted by a higher authority, or the rule enacted later, or the more specific rule, or something of that sort. A legal system may also prefer the rule supported by the more important principles."[170]

Alexy, who does not distinguish between principles and policies,[171] makes a similar point when he states that a conflict between two rules can only be resolved in that either an appropriate exception is read into one of the rules, or at least one of the rules is declared invalid. The question of which rule should be declared invalid or into which rule an exception should be read can be solved by maxims such as *'lex posterior derogat legi priori'* or *'lex specialis derogat legi generali'*, but it is also possible to proceed according to the substantive importance of the conflicting rules. Competing principles should be resolved in a fundamentally different way. If two principles compete, one of them must be outweighed. This neither means that the outweighed principle is invalid nor that it has to have an exception built into it. The principle continues to exist and may itself outweigh the other principle in other circumstances. If two rules conflict, one of them has to be declared invalid. As a consequence, conflicts of rules are played out at the level of validity and competitions between principles are played out in the dimension of weight.[172]

Thus, Alexy basically agrees with Dworkin's distinction between rules and principles. The grounds which underlie this distinction are, however, fundamentally criticized by Alexy. He states that Dworkin's all-or-nothing criterion for the identification of rules is inextricably linked to the theoretical possibility of listing all exceptions to a rule, which theoretical possibility would be absent in case of principles. Alexy challenges this position by pointing out that a principle may be a reason for a court for adding an exception to a rule (assuming that the court would be competent to do so under the constitution concerned).

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168 Dworkin 1977, p 25.

169 Dworkin 1977, p 25-26.

170 Dworkin 1977, p 26-27.

171 This is important, because in Dworkin's theory individual rights – which he calls 'principles' - are clearly more important than 'policies', because a right of an individual can only be limited by competing rights of other individuals and not by policies. This is problematic for the present study, because the rights which individuals derive from the EU free movement provisions should not automatically trump the policies which Member States pursue through their tax systems (chapter 3).

172 Alexy 2002, p 49-50.

If the counter-instances of a principle are numberless, then likewise the instances of its own application are also numberless.[173] If that is true, then the number of exceptions to a rule can also not be listed, not even theoretically. As a consequence, Dworkin's all-or-nothing criterion for the identification of rules cannot be upheld, because principles cannot be applied in this fashion. Thus, both rules and principles may appear only *prima facie*. Their *prima facie character*, however, may be fundamentally different due to 'formal principles'. The setting aside of a rule raises a host of issues that do not arise when a principle is set aside, due to the fact that the institution that has legislated the rule has already made a judgment on how the relevant background principles apply to the regulatory context specified by the rule.[174] A principle can be outweighed by another principle. By contrast, a rule is not automatically trumped when the competing principle is of greater weight than its own underlying principle on the facts of the case. Here, Alexy explains, there are other – formal – principles which also need trumping, such as the one that rules passed by an authority acting within its jurisdiction are to be followed, and the principle that one should not depart from established practice without good reason. Only if these formal principles would not apply in a particular jurisdiction do rules and principles have the same *prima facie* character.[175] Since these formal principles do not apply if a tax measure is tested against the EU free movement provisions, therefore national tax rules – which are an emanation of the principle of sovereignty – and EU principles have the same *prima facie* character. This fact that both rules and principles may appear only *prima facie* – here Alexy disagrees with Dworkin – does not mean that no meaningful distinction between rules and principles can be made. According to Alexy, the doctrine of collision, already briefly touched upon, is a meaningful criterion.[176] This can be explained by giving two examples. These examples are derived from Dutch case law and not from ECJ case law, because the analysis in Part II of the present study should, in principle, not be influenced by ECJ case law. After all, Part III of the present study will discuss this case law in the light of the model developed in Part II.

In 1993 the Dutch Supreme Court (*Hoge Raad*) decided the case of a Dutch BV (a limited liability company) which was effectively managed in Ireland and which had suffered a loss.[177] According to Dutch internal law, this loss should be available to carry forward in future taxable years in the Netherlands (under the Dutch corporate income tax act, a BV incorporated under Netherlands law is deemed to be a tax resident of the Netherlands). Under the Ireland-Netherlands tax treaty, however, BV was regarded as a tax resident of Ireland. As a consequence, its results were taxable only in Ireland. The *Hoge Raad* resolved the conflict between the tax treaty and the corporate income tax by disapplying the latter: the loss could not be taken into account in the Netherlands. This case is a typical example of a *contradiction* of rules. One rule permits something which the other rule prohibits. This conflict is resolved by declaring one of the rules as not valid and thus removing it from the legal order.

[173] Alexy 1985a, p 16.
[174] Kumm 2004, p 578.
[175] Alexy 2002, p 58.
[176] Compare Huerta 2009, p 190-191.
[177] HR 17 February 1993, No. 28260, BNB 1993/163.

The *Hoge Raad* took a totally different approach in 1979 in a case concerning a disabled person who wanted to deduct costs which related to his transportation by car (a certain amount per kilometre).[178] The taxpayer claimed that he suffered extraordinary costs because he had no other means of transportation due to his disability. The Court of Appeal refused this deduction on the ground that similar taxpayers without the disability suffered similar car transportation costs. Hence, the costs suffered by the taxpayer could not be attributed to his disability. The Court of Appeal rejected the taxpayer's argument that some statements made by the tax inspector over the phone had given rise to legitimate expectations that the costs would be deductible. Before the *Hoge Raad* the taxpayer argued that the Court of Appeal made an error in law by holding that the principle of legitimate expectations does not set aside the strict application of the law in this case. The *Hoge Raad*'s reply to this argument is extremely interesting, because it reveals that this case is not about a contradiction of rules but rather about an *area of tension* between colliding norms. It first stated that the case at issue concerns the question of whether the principle that the law should be applied conflicts with the principle of legitimate expectations to such a degree that the law should not be applied. This question should be answered by balancing the principle of legality against the principle of legitimate expectations. The *Hoge Raad* subsequently formulated detailed rules which the lower courts should follow when performing this balancing exercise in concrete situations.

The example of the loss-making dual resident BV concerned a conflict between two rules which was solved by placing one of the rules outside the legal order. The example of the disabled taxpayer concerned a tension between two principles which was not resolved by disapplying one of the principles, but by giving precedence to one of them under particular circumstances. Accordingly, the conflict between rules is an inside-outside problem, whereas a collision between principles takes place within the legal order.[179] This is what Alexy means with the doctrine of collision: a conflict between two rules can only be resolved in that either an appropriate exception is read into one of the rules, or at least one of the rules is declared invalid – for example by maxims such as '*lex posterior derogat legi priori*' or '*lex specialis derogat legi generali*' – whereas a conflict between principles is resolved in a weighing process. This neither means that the outweighed principle is invalid nor that it has to have an exception built into it. The principle continues to exist and may itself outweigh the other principle in other circumstances. A comparison with the conflict between tax sovereignty and EU free movement shows that this conflict is not played out at the level of validity but at the level of weight. As stated earlier, tax measures enacted as a result of the exercise of a State's tax sovereignty thus appear only *prima facie* in the context of EU free movement.

The question arises as to why principles collide in the manner just described. According to Alexy, this has to do with a deeper distinction between principles and rules. Principles are norms which require that something is realized to the greatest extent factually and legally possible. They prescribe the highest degree of realization of an ideal or value under certain legal and factual conditions.[180] Principles are thus optimization requirements

[178] HR 26 September 1979, No. 19250, BNB 1979/311.
[179] Alexy 1985a, p 19.
[180] Taekema 2000, p 12.

which are characterized by the fact that they can be fulfilled in various degrees and that their fulfilment depends on factual and legal possibilities. Their extent is therefore in concrete cases determined by competing rules and principles.[181] Typically, the principle itself is not capable of determining its own extent in the light of competing principles and what is factually possible.[182] This means, for instance, that budgetary reasons can never justify an infringement which a tax measure imposes on a competing principle.[183] If it were otherwise, the extent of tax sovereignty would be unlimited and absolute. In contrast to a principle, a rule is a closed norm, the scope of which has already been determined by the authority which has passed it. Rules are norms which are always either fulfilled or not. If a rule has been adopted by the competent authority, then the requirement is to do exactly what it says. In such a case, rules contain *fixed points* in the field of the factually and legally possible.[184] They cannot be fulfilled in various degrees. An example may clarify this. In the Netherlands, the tax inspector can only impose an additional tax assessment if a 'new fact' has become known after the original tax assessment was imposed or the taxpayer has acted in bad faith.[185] This rule is the result of a weighing process performed by the legislator of various principles: the principles of legitimate expectations, legality, careful public administrative procedure and equality. This process has resulted in a rule. As a result, there is no room for the court to come to another appraisal. Canaris has taken a similar stance in this respect. He states that principles, unlike rules, have an explicit axiological content. They lack rules in order to be realized. Therefore, principles receive their meaning only by means of a dialectic process of complementation and limitation.[186]

Alexy explains that the observation that principles are optimization requirements explains their characteristics.[187] First, this observation explains why principles collide in the manner just described. Second, it clarifies the different *prima facie* character of rules and principles. Principles are always *prima facie* reasons and rules are *definitive* reasons, as long as no exception has been read into them. If the court takes the position that such an exception should be added to the rule, it has to have a very strong argument because the rule has been adopted by the competent authority. In such a case, the reason for adding an exception to the rule should also be able to outweigh the principle that rules passed by an authority acting within its jurisdiction are to be followed. Thus, the *prima facie* character of rules and principles differs. Principles are the starting point of a balancing exercise, whereas rules are rather the result of balancing the relevant competing interests. Principles represent reasons which can be displaced by other reasons. The circumstances under which one principle takes precedence over another constitute the conditions of

181 Alexy 1985a, p 19-20. See also Alexy 2002a, p 70, and Alexy 2009, p 2.

182 Sieckmann defines the notion of a principle slightly differently. He sees principles as normative arguments which form at the same time the object of a balancing exercise and the reasons for that exercise; Sieckmann 2007, p 37.

183 See, for instance, HR 14 June 1995, No. 29254, BNB 1995/252, § 3.4.4, where the Dutch Supreme Court stated that budgetary reasons cannot justify a breach of the principle of equality enshrined in Article 26 of the International Covenant on Civil and Political Rights (ICCPR).

184 Alexy 2002, p 47-48.

185 Article 16 of the *Algemene wet inzake rijksbelastingen* (General Tax Act).

186 Canaris 1983, p 50, 53 and 55, summarized by Ávila 2007, p 9.

187 Alexy 1985a, p 20.

a rule which has the same legal consequences as the principle taking precedence: the result of the balancing act is enshrined in the rule. Alexy calls this the *Law of Competing Principles*.[188] The balancing activity of the courts and scholars may over time result in rules with a relatively high degree of precision stating which principle takes precedence in which situation. The content of the rules thus formulated will differ depending on the competing principles involved.[189] This goes back to the idea of categorization, briefly discussed in chapter 3.[190]

4.3 The nature of a principle implies its widest possible scope

Before one can identify a potential conflict between principles one has to identify the *prima facie* scope of the principles involved. It has just been explained that principles should be regarded as optimization requirements which should be realized to the greatest extent legally and factually possible. This nature of a principle necessitates that it has the widest possible scope. Principles are optimization requirements and in order to achieve the optimum between competing principles it is necessary that their widest possible scope is adopted in the beginning of the optimization process. After all, if a narrow scope were adopted, this would mean that no further fine-tuned optimization would be possible. Alexy explains this by distinguishing between two theories on the scope of a right and its limit. The 'external theory' presupposes that there are two things: a principle and its limit. First, there is the principle in itself, which is not limited, and secondly there is what is left over once the limit has been applied (the principle as limited). Alexy points out that the external theory can accept that principles in legal systems appear mostly as limited rights, but it insists that they are also conceivable without limits. As a consequence, there is no necessary relationship between the concept of a principle and the concept of a limit. This relationship "arises first with the requirement external to the right itself to reconcile it with the rights of other individuals or with other individual rights and collective interests." According to the 'internal theory', however, there are not two things, a right and its limit, but only one: a right which has a certain content. The idea of a limit is in this theory replaced by that of extent or scope. In the internal theory, doubts about the extent of principles are not doubts about how far they can be limited, but doubts about their content.[191] An example given by Gerards and Senden illustrates that this is not a purely theoretical discussion. If hate speech is defined as a form of 'expression' that is protected by the freedom of expression, it clearly comes within the scope of article 10 of the ECHR. This means that restrictions of hate speech, such as imposing a penalty on someone for distributing racist flyers, must be justified. As a consequence, the ECtHR would be competent to examine the reasonableness of the national justification and to give a binding judgment on the matter. By contrast, if freedom of expression were defined more narrowly, cases of hate speech might fall outside the scope of article 10 of the ECHR. That would mean that there would be no need to justify a penalty imposed because of hate speech,[192] unless, for example, another possibly applicable principle would so require.

188 Alexy 2002, p 54.
189 Alexy 2002, p 108. See also Gribnau 1998, p 57.
190 See Gerards & Bomhoff 2007.
191 Alexy 2002, p 178-179.
192 Gerards & Senden 2009, p 620.

Alexy argues that the question of whether the external or the internal theory is correct depends upon whether constitutional norms – e.g. free speech, freedom of profession or, as we shall see in section 6.1, the EU free movement provisions – are seen as rules or principles, that is, whether they give rise to definitive or *prima facie* positions. In the event that they would give rise to definitive positions, the internal theory should be adopted. In the event that they would be viewed as *prima facie* positions, the external theory should apply. In Alexy's theory of principles the external theory should be adopted. Principles include a guaranteed *prima facie* right which is subsequently limited (section 4.2). They require a maximally extensive protection of interests. The limitation of a protected interest is thus always a limitation of a *prima facie* position established by the principle. Both principles and rules are capable of limiting a principle's *prima facie* position.[193]

The external theory leads to a *model of two domains*. The first domain is that of potential infringement cases, the second that of the actual ones. A case is a potential infringement case whenever a principle is "relevant", no matter how surely the principle is outweighed by competing principles. Alexy rejects any form of threshold which would have to be met before it can be said that a certain principle *prima facie* competes with another principle. The adoption of the widest possible scope of a principle enables the courts to optimize all relevant principles involved, without the risk of not meeting a certain threshold. It may thus be said that a wide scope of principles derives from their very nature as optimization requirements.[194]

Alexy realizes that a wide conception of the scope of a principle may be criticized because it may, at first sight, lead to an unacceptably wide jurisdiction of the courts. He argues, however, that this is not a necessary consequence of a wide conception of scope. After all, the doctrinal conclusion that a certain act falls within the scope of a principle does not at all mean that it will not be covered by a limitation (e.g. another principle).[195] We shall now turn to these limitations.

4.4 The limits to principles; no 'compelling interest' test

It has been shown in section 2.3 that current ECJ case law formally requires that only 'compelling' or 'overriding' reasons in the general interest can serve as a limit to the principle of free movement. It will be argued in the present section, however, that any competing principle may be a limit. Although this seems to be going against settled ECJ case law, chapter 8 will show that no practical difference exists between both approaches, as a result of which the least complicated formulation should be adopted (i.e. the formulation proposed here).

Principles require a maximally extensive protection of interests. The limitation of these interests thus implies a limitation of the *prima facie* position of a principle. This brings Alexy to the following definition of limits to principles: limits to principles are norms

[193] Alexy 2002, p 179-184.
[194] Alexy 2002, p 214-217.
[195] Alexy 2002, p 216. It is, therefore, doubtful whether a wide scope actually leads to a growth in the number of cases pending before the courts.

limiting *prima facie* positions of principles.[196] Alexy then turns to the question of what it is that turns a norm into a limit. He starts with a general point. A norm can only limit a principle if it is itself 'constitutional'. This means that norms are only limits to principles (e.g. constitutional rights) if they are themselves *compatible with the constitution*[197] (or in case of EU law: the Treaty on European Union and the Treaty on the Functioning of the European Union). The importance of this cannot be underestimated. It means that all norms which are compatible with norms of a similar status – e.g. enshrined in the constitution or in the TEU and TFEU – are capable of being a limit to a principle. No additional requirements, such as a certain weight of the norm before it can serve as a limit, need to be met.

The question arises as to how to identify limits to a principle. Commanding and prohibiting norms have by definition a limiting character, so that they come within the scope of the principle limited by them. A different approach applies to formative powers. Alexy gives the norms of private law institutions as an example. Without the norms of property law the constitutional guarantee of property would be meaningless. So the norms which give meaning to this constitutional guarantee cannot be regarded as limiting it. In other words, the creation of (private law) powers *as such* has no limiting character. Sometimes, however, a power may be removed. According to Alexy such a removal would have a limiting character if it hinders the realization of a principle. If the removal of a power obstructs the realization of a principle, it is not merely outworking that principle, but it is limiting it.[198] An example from tax law relates to the impossibility for a company to carry forward losses in case of a change of ownership (e.g. 50% of the shares in the company are acquired by a third party). This removal of the power to offset losses against future profits may equally limit the realization of a principle.

As stated, commanding and prohibiting norms addressed to the citizen, as well as norms removing certain powers, may function as a limit to a constitutional right (a principle). According to Alexy it is of fundamental importance to distinguish between rules and principles in this context.[199] A *rule* limits a principle when, if it is applicable, a definitive 'no-liberty' or 'no-right' of the same content applies in place of a constitutional *prima facie* liberty or right. An example of a no-liberty is the obligation to drive on the right side of the road. This rule limits the basic principle of freedom of action (the general right to liberty of Article 2 of the German Basic Law). An example of a no-right concerns the obligation to grant the tax inspector access to one's building or premises insofar as this is deemed necessary for purposes of fiscal supervision (Article 50 of the Dutch General Tax Act). This limits the principle of Article 8 of the ECHR in the sense that the owner of these premises has no right to invoke the *prima facie* right to respect for private and family life. A *principle* can also act as a limit to another principle, but the mechanism of limitation is different. As Alexy explains, limiting principles on their own are not capable of putting the individual in specific, definitely limited, positions (no-liberties, no-rights). In order to reach a definitive limitation one needs to balance the relevant principle with its limiting

196 Alexy 2002, p 181-182.
197 Alexy 2002, p 182.
198 Alexy 2002, p 219-221.
199 Alexy 2002, p 183-184.

principle. Thus, the extent to which principles limit another principle is not clear from the start – this is the case with limiting rules – but becomes apparent only after a balancing exercise. Alexy gives the following definition of limiting principles: a principle is a limit to another principle if there are cases in which it is a reason that in place of a *prima facie* liberty or right, a definitive no-liberty or no-right with the same content applies.

Thus, principles are capable of being limited in the light of countervailing principles. The extent of this limitation is itself also limited. An actual limitation of a (constitutional) principle arises only if that principle has a greater weight than the principle underlying the limit in the concrete situation at hand. The question arises of whether the limit should meet additional criteria besides the possession of sufficient weight in such a case and the requirement that it is compatible with the constitution.[200] Article 19(2) of the German Basic Law seems to answer this question positively, because it provides: "In no case may the essence of a basic right be affected." This provision seems to set another criterion to a norm before it counts as a limit by prohibiting action in the core of each right (a guarantee of an inalienable core as a limit to limits). Alexy takes the position that this provision is redundant in the theory of principles. He explains this position by distinguishing between absolute and relative guarantees of an essential core. According to the relative theory, the essential core is what is left over after a proportionality analysis has been performed (is the limit suitable, necessary and well balanced in relation to the limited principle), even if in the end nothing is left of the principle in an individual case. This would make Article 19(2) of the German Basic Law redundant. According to the absolute theory, however, there is a core to each principle which cannot be limited under any circumstances. Alexy rejects the absolute theory which implies that there is such a thing as absolute principles. He explains this as follows. Principles can be related either to collective interests or individual rights. If an absolute principle relates to a collective interest, constitutional rights of others would be non-existent in that area. Obviously, this cannot be the case. If an absolute principle guarantees individual rights it may result in a conflict with itself if the right it protects of one person comes into conflict with the similar rights of other individuals; in such a case the latter must give way, which is inconsistent. From this, Alexy draws the conclusion that absolute principles are either incompatible with constitutional rights or can only apply where the rights which they create benefit just one person.[201] This shows that principles are by their very nature relative and never absolute. This does not mean, however, that relative limits cannot look like absolute limits in concrete cases. Alexy argues that the more a principle is restricted, the more 'resistant' it gets: the strength of the countervailing principles has to grow disproportionately. This, Alexy argues, corresponds to the 'law of diminishing marginal utility'. There are thus conditions under which it is almost certain that no countervailing principle will take priority. The level of certainty, however, remains a result of the relation of the different interests involved.[202]

It will be clear from the above that a 'compelling interest' test does not form a part of Alexy's theory. The process of optimization of competing principles evolves around the aim or reason of the measure which infringes a principle. Alexy's theory does not

[200] Alexy 2002, p 192-193.
[201] Alexy 2002, p 62.
[202] Alexy 2002, p 195.

require that this aim has any special weight in advance. It does not have to be 'compelling' or in any other way special. Also, nothing in Alexy's theory prioritizes rights from the start. There is no conceptual hierarchy between the principle and its limitations, because both the principle and its limitations are interests that seek optimization of legitimate interests.[203] Neither does it seem reasonable to overprotect certain interests through a compelling interest test. Indeed, if proportionality analysis, taken seriously, means that all relevant considerations must be taken into account and accorded the weight they deserve, then what could justify protecting an interest beyond what proportionality requires?[204] According to Kumm, the absence of a compelling interest test has at least two advantages. In the first place, a court which uses the model of constitutional rights as principles might plausibly produce better outcomes because of the emphasis this model places on reason-giving in concrete cases. In the second place, this reason-giving in concrete cases without the development of a list of possible 'compelling' aims improves the way in which the courts justify their decisions to the public. Such a list may be perceived as exhaustive and would in each case require an in-depth investigation into precedents which would have to reveal whether a certain motive is sufficiently fundamental or compelling. This may result in a public rights discourse which is "shrill, dogmatic, and categorical".[205] A possible illustration of this is provided by Lang who has argued that "the ECJ should refrain from introducing new grounds of justification that lead to uncertainty".[206] It is, in my view, a fundamental misconception that a court would itself 'introduce' justifications, because a court merely examines which objectives underlie a certain measure and whether these objectives may serve as a limit to a principle. Lang is, in my view, however right to point out that the approach advocated by Kumm may lead to legal uncertainty if court decisions become wholly unpredictable. This seems to be a temporal problem, because the case law tends to arrive at categorizations for similar problems: the collisions of principles in similar cases tends to lead to 'rules' which are relatively clear to taxpayers and Member States.[207]

4.5 Proportionality analysis: principles as optimization requirements

4.5.1 Introduction

It has been argued above that principles are norms which require the greatest possible realization of something relative to what is factually and legally possible. In other words, principles are to be realized to the greatest extent possible given empirical and normative constraints.[208] They should be accorded their widest possible scope. At the same time, they should accept any other principle as their limit. According to Alexy, this definition of a principle implies the principle of proportionality:

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203 Borgmann-Prebil 2008, p 341.
204 Kumm 2004, p 593.
205 Kumm 2004, p 595.
206 Lang 2009, p 113.
207 See, for instance, the case law on CFC legislation (Case C-196/04 *Cadburry Schweppes* and Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation*). Compare also Cordewener 2002, p 34, who states that the level of certainty will increase with more ECJ judgments.
208 Rivers 2002, p xxviii.

> "It has already been hinted that there is a connection between the theory of principles and the principle of proportionality. This connection is as close as it could possibly be. The nature of principles implies the principle of proportionality and vice versa. That the nature of principles implies the principle of proportionality means that the principle of proportionality with its three sub-principles of suitability, necessity (use of the least restrictive means), and proportionality in its narrow sense (that is, the balancing requirement) logically follows from the nature of principles; it can be deduced from them."[209]

The test of *proportionality in its narrow sense*, that is, the requirement of balancing, derives from its relation to the *legally* possible. The tests of necessity and suitability follow from the nature of principles as optimization requirements relative to what is *factually* possible. Thus, the latter tests take the aim of the tested rule or principle against another principle as a given, whereas the former test may, wholly or partially, set aside that aim. In the words of Alexy, "[t]he question whether any of the alternatives should be chosen at all is not a question of the factually possible, that is, of necessity, but a question of what is legally possible, that is, one of balancing".[210]

Rivers has argued that the test of suitability can be subsumed under the test of necessity: any State action which is necessary, in the sense of being the least intrusive means of achieving some end must, by definition, be capable of achieving the end in the first place. It has to be suitable. Nevertheless, Rivers is of the opinion that the test of suitability serves a practical function as an initial filter. The test of proportionality in its narrow sense also has a threshold counterpart, because proportionality presupposes that the State action in question be directed towards the pursuit of an end which is generally legitimate. If the end is illegitimate, then no limitation of any right is justifiable.[211] In short, the entire principle of proportionality could be seen as consisting of two threshold requirements (i. pursuit of a legitimate end and ii. by an effective means, which are both conditions which are either fulfilled or not) and two optimization requirements (iii. the use of the least intrusive means and iv. to achieve something worth achieving given the costs involved, which are both conditions which require a fine-tuning or optimization of competing principles).

Kumm describes the four phases of the proportionality test in a slightly different way. According to him two of these – suitability and necessity – focus on empirical concerns, demanding that principles be realized to the greatest extent that is factually possible. The other two – legitimate ends and balancing – are normative, requiring that principles be realized to the greatest extent possible in the light of countervailing norms.[212]

In contrast to Rivers and Kumm, Alexy does not require that the norm limiting a principle has a 'legitimate aim'. At least, he is not using this terminology. The question of whether the restricted principle has a greater weight than the principle underlying the limit has to be answered within the framework of the last phase of the proportionality test (proportionality in the narrow sense or the balancing requirement). It will be argued in

[209] Alexy 2002, p 66. Footnote omitted.
[210] Alexy 2002, p 68.
[211] Rivers 2002, p xxxii.
[212] Kumm 2004, p 579. See also Kumm 2006a, p 348.

section 4.5.2, however, that a 'legitimate aims' test is implicit in Alexy's theory (if rephrased as a 'respectful aim' test). In addition, it will be argued that it is better to replace the 'necessity' test by two separate tests which relate to the 'degree of fit' and the 'subsidiarity' of norms in the optimization process (section 4.5.4).

A rule or principle which is tested against another principle is allowed to stand if the four phases of proportionality analysis are met: a. legitimate ends, b. suitability, c. necessity and d. balance. They will be discussed in more detail below. In the following paragraph I will try to give a precise definition of the first phase of the optimization model. For reasons I will explain shortly, I will not use the term 'legitimate ends', but rather develop a 'respectful ends' test.

4.5.2 Respectful aim

Introduction

According to the above-mentioned writers, the first phase of the proportionality test is of a normative nature. This view is generally accepted in literature.[213] It requires that a judgment be made on whether a certain reason is 'acceptable' as a potential limit to a principle of not. In other words, the court should assess whether a rule (or principle upon which the rule is based) which is tested against a principle has a legitimate aim. Current literature does not, however, define the criteria according to which the question should be answered of whether a certain measure has a legitimate aim or not. Therefore, an attempt will be made here to formulate such criteria. This attempt will replace the 'legitimate aim' test with a 'respectful aim' test. This test will prove to be pivotal to the argument made in the present study and evolves around the idea of a twofold neutrality between tax sovereignty and free movement.

The test of a 'respectful aim'

Firstly, in the case of a conflict between a rule and a principle, the principle may require that an exception is added to the rule in certain circumstances. Thus, both rules and principles may appear only *prima facie* (section 4.2). Their *prima facie* character, however, may be fundamentally different due to 'formal principles' which may require that rules passed by an authority acting within its jurisdiction be followed. Since these formal principles do not apply if a tax measure is tested against the EU free movement provisions, national tax rules – which are an emanation of the principle of sovereignty – and EU principles have the same *prima facie* character. The widest possible scope of principles – i.e. both the restricted principle and its limit – should be adopted in the theory of principles (section 4.3).

Secondly, Alexy has shown that principles can never be absolute (section 4.4). This means that neither the restricted principle nor its limit can be absolute in the sense that they can never be outweighed. It should always be possible to perform a balancing exercise. If one of the principles regards itself as inviolable this is impossible. A principle which does not recognize other principles cannot engage in balancing with another principle (which it would regard as irrelevant). The balancing requirement of the principle of proportionality

[213] See Gerards 2005, p 32-34, and the literature there referred to.

requires that the greater the degree is of non-satisfaction of, or detriment to, one principle, the greater the importance must be of satisfying the other.[214] It is clear that principles or (tax) measures which do not accept that they may be outweighed, constitute such a high degree of infringement of another principle – which is completely neglected – that these principles or rules will always lose in the balancing test.

Thirdly, as stated in section 4.2, a principle itself is not capable of determining its own extent in the light of competing principles and what is factually possible. This extent is determined by proportionality analysis (suitability, necessity and balance), which should be able to be performed. This means that neither the extent of the restricted principle nor the extent of its limit can be determined in advance by reference to that principle or that limit itself. Principles and limits which are nevertheless characterized by the wish to determine their own extent and, consequently, to disregard other principles cannot be qualified as principles or limits. In other words, the goal of a limit to a principle should be external to the goal of being a limit. And, conversely, the restricted principle should accept *in abstracto* the possibility of being limited.

These three observations lead to the following definition of the requirement of a 'respectful aim', which has to be observed by the limit to a restricted principle: a limit to a principle does not have a respectful aim if it has no other objective than limiting that principle. Also, a restricted principle does not have respectful aim if it does not accept that it may be limited. In both cases, the principle and limit do not 'respect' each other, hence the terminology of 'respectful aim'.[215] In my view, no other requirements may be imposed, apart from being formally and substantively compatible with other principles with a similar status (Alexy calls this, in a German context, 'compatibility with the Constitution'; in a European context one would read 'compatibility with the TFEU', for instance with the prohibition of State aid or the common environmental policy). This means, for instance, that budgetary reasons can never justify an infringement which a tax measure imposes on a competing principle.[216] If it were otherwise, the extent of tax sovereignty would be unlimited and absolute: it would not accept other principles as limits.

The replacement of the 'legitimate aim' test by a 'respectful aim' test takes the sting out of the normative character of the 'legitimate ends' test, because the 'respectful ends' test defines in advance which objectives of a limiting measure are not acceptable. Once the objectives of a limiting measure are clear, no further normative judgments are necessary; it needs only to be determined whether the objectives fall under the definition. This is an advantage of the 'respectful ends' test, because it is not desirable that an assessment model starts with a request for normative judgment: such a judgment should be the end of the reasoning rather than the beginning.

The definition of a 'respectful aim' places a very high emphasis on the objective of a limit to a principle which may be difficult to determine. Gerards has shown that at least two difficulties may arise when assessing the aim of a measure.

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214 Alexy 2005, p 573. See also Alexy 2009, p 7.

215 Ávila 2007, p 101, reaches essentially the same conclusion under the postulate of 'prohibition of excess'.

216 See, for instance, HR 14 June 1995, No. 29254, BNB 1995/252, § 3.4.4, where the Dutch Supreme Court stated that budgetary reasons cannot justify a breach of the principle of equality enshrined in Article 26 of the International Covenant on Civil and Political Rights (ICCPR). The same is true for the ECJ case law discussed in section 8.3.2.3.

How to determine the aim of a measure?
Firstly, it may be difficult to discover which aim exactly underlies a certain rule. This is a problem every court is familiar with; it should be solved though the normal rules of interpretation.[217] They can have recourse to the legislative history of the measure, the system of the law of which the measure is a part, the social and political circumstances under which it was enacted and the effects generated by the provision.[218] If a rule *prima facie* infringes a certain principle without any known 'real' objective, its effects become more important. If these effects are such to infringe upon a certain principle, this may be an indication that the objective of the legislature has not been respectful. As the WTO Appellate Body held in Japan Alcohol:

> "We believe it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.
> Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application, as the Panel rightly concluded in this case. Most often, there will be other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case."[219]

How to deal with a plurality of objectives?
Secondly, a rule may pursue various aims at the same time: a plurality of objectives. If one of the aims is 'legitimate' – or, in my terminology, 'respectful' – but the other is not, the question arises as to whether the rule is acceptable or not. Gerards distinguishes two situations: a provision may pursue different objectives with a similar value, but it is also possible that the aims are of differing weight. In the latter situation the main objective may be rather general, such as ensuring public safety. Its sub-objectives are then subsidiary to the main goal. Both situations require a different approach. In the case of a plurality of objectives with the same weight, Gerards observes that the majority of scholars is of the opinion that the rule can be saved by the 'legitimate' objective even if one or more of the other objectives are not 'legitimate'. In case of a plurality of objectives which have a hierarchical relationship – a primary goal with one or more sub-goals – the majority of scholars argues that not only the principle aim but also all sub-goals should be 'legitimate'. If this were different, these authors argue, it would be too easy to hide an 'illegitimate' narrower aim behind the 'legitimate' broader objective. Gerards, however, is of the opinion that there are cases in which the distinction between aims of equal and non-equal weight cannot be fully upheld. In her opinion, it is possible to think of cases where the 'legitimate' objectives of a measure are so important that the classification should be maintained, even if at the

[217] Gerards 2005, p 35.
[218] Gerards 2005, p 39.
[219] WTO Appellate Body Report of 4 October 1996 (*Japan Alcohol*), No. AB-1996-2, p 29.

same time there are unacceptable goals subsidiary to the main one. According to Gerards, it is therefore preferable in this situation to maintain the same methodology as with goals of equal weight, which means that the courts should investigate, on a case-by-case basis, whether the measure would also be justified if the unacceptable goal were eliminated.[220] I agree with the objections brought forward by Gerards. The distinction between aims of equal and non-equal weight is useful in giving weight to the various objectives. It may, for example, occur that a certain sub-goal cannot fully be achieved because that would mean that the primary goal would become illusionary. In other words, a disrespectful sub-goal may be justified by the primary goal. Another way of looking at the issue of plurality of objectives is to approach it from the perspective of the affected principle rather than from the perspective of the rule in question. This affected principle serves as a limit to the principle which underlies the rule with a plurality of objectives. The application of the affected principle should respect the other principle in the sense that it accepts that it can serve as its limit. This may explain why an illegitimate sub-goal may be 'justified' by the primary goal if the sub-goal is an essential element of the underlying principle. An example may clarify this: a system of group contribution which does not allow a company resident in one Member State to make a tax deductible group contribution to its parent company resident in another Member State. The primary goal of a tax system is structural in nature: the collection of resources for the State. The sub-goal of the measure in question is to do so in an equitable fashion and to give groups of companies the possibility to have profits taxed at the level of the best-placed group company by making a tax deductible contribution of profits by one group company to another group company in the hands of which the profits are then taxed. This makes it, among other things, possible that losses within a group of companies can be used to offset profits made by the group. A further sub-goal of such a group contribution regime is that the primary goal – collecting resources for the State – is not jeopardized by the first sub-goal (equitable taxation), as a result of which the possibility of making group contributions is limited to domestic group companies. The extension of the group contribution regime cross-border would have meant that groups of companies would be allowed to choose freely the Member State in which the profits of the group company are to be taxed. This would have been a result which would jeopardize the primary goal in a disproportionate way, so that the limitation to domestic group companies – which may appear illegitimate – is justified by the primary goal. Another way of putting it, and this is what the ECJ has done in the case of *Oy AA,* is to say that the possibility of cross-border group contributions would severely jeopardize inter-nation equity. It would undermine the system of the allocation of the power to tax between Member States because, according to the choice made by the group of companies, the Member State of the subsidiary would be forced to renounce its right to tax the profits of the transferring company in favour of the Member State in which the receiving company has its establishment. Ultimately this would mean that the choice of the Member State of taxation would be a matter for the group of companies.[221] In other words, if taxation were a voluntary choice and not an obligation, this would essentially deprive the Member State concerned of its right to collect taxes and, therefore, its tax sovereignty as such. The

[220] Gerards 2005, p 40-41.
[221] Case C-231/05 *Oy AA*, § 56 and 65.

principle of free movement cannot lead to such a conclusion because it would, in that scenario, not recognize the principle of tax sovereignty as a possible limit: its aim would become disrespectful.

4.5.3 Suitability

The requirement of suitability is of an empirical nature. It entails an optimization requirement relative to what is factually possible (as opposed to what is legally possible).[222] The test of suitability takes the respectful aim as a given and examines whether the rule at issue is apt to attain the objectives pursued. It should in other words be 'capable' of actually protecting the interest that needs to be protected, meaning that there must be a causal relationship between the measure and the objective.[223] A measure is appropriate if it is a tool, in the abstract and in general, to further the purpose.[224] The test of suitability is none other than an expression of the idea of Pareto-optimality: one position can be improved without detriment to another.[225] Alexy gives the example of a rule on retail trade which prohibits the sale of cigarettes through a vending machine on someone's property without permission. Permission can be granted if the applicant demonstrates that he has the 'necessary expertise'. This requirement of proof of commercial ability *prima facie* infringes the freedom of profession. The aim of the restrictive rule was to protect consumers from financial and health risks. It is clear, however, that a ban on placing vending machines unless commercial ability has been proven is not a suitable means to achieve these ends. This requirement can thus be dropped without any harm to both interests involved: freedom of profession and protection of the consumer. This equals the attainment of Pareto-optimality.[226] Another example from Dutch practice concerned a pharmacist who asked a trainee, who was of the Islamic faith, to take off her headscarf while working. If the trainee would not do so, she would no longer be welcome to work in the pharmacy. The reason for this request was, according to the pharmacist, to ensure that all his employees continued to work with the utmost precision, thereby emphasizing that any mistake in a pharmacy implies a serious risk for the public health. The pharmacist feared that the headscarf could lead to an intense debate among his staff during working hours which would jeopardize their carefulness. The Equal Treatment Commission held that the ban on the headscarf constitutes an act of indirect discrimination on grounds of religion which is *prima facie* prohibited. The objective of ensuring a working environment in which the utmost precision is ensured is a legitimate objective which is in principle capable of limiting the principle of equal treatment. However, the ban on the headscarf is – according to the Commission – not suitable to achieve that objective. A prohibition of the headscarf can by no means prevent a discussion taking place about religious topics. As a consequence, the infringement of the principle of equal treatment could not be limited

222 Alexy 2002, p 67. See also Alexy 2009, p 6.
223 Jans 2007, § IV.
224 Ávila 2007, p 117.
225 Alexy 2002, p 398.
226 See also Alexy 2009a, p 15.

by the need to ensure a careful working environment.[227] The prohibition of the headscarf could be dropped without any harm to one of the principles involved. In such a case, Pareto-optimality requires that it is cancelled.[228]

4.5.4 Necessity

Introduction

The requirement of necessity derives from the very nature of principles, just as the suitability test.[229] It requires that of two broadly equally suitable means, the one which interferes less intensively should be chosen. Thus it entails an optimization requirement relative to what is factually possible. The necessity test can be divided into two sub-tests: a test which examines the degree of fit of a measure and a test which examines the subsidiarity of a measure.

Over- and underinclusiveness, or the assessment of the degree of fit

Gerards explains that the assessment of the over- and/or underinclusiveness of a classification relates to the degree to which it matches the aim of the measure.[230] Overinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too widely. Underinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too narrowly. Thus, both over- and underinclusiveness share a comparable defect: a shortcoming in the precision of the definition of the classification with regard to the intended goal. The solution to the problem of over- and underinclusiveness is to adjust the definition of the group so that it meets its objective. As Gerards observes, it is important that the formulation of each classification matches as closely as possible the intended goal, so that the degree of over- and/or underinclusiveness is kept to a minimum. Only in this case, Gerards notes, can it be avoided that persons unjustifiably fail to receive certain benefits or are unjustly burdened or disadvantaged.[231] A good example in tax law is that of anti-abuse measures: these are often designed in such a way that they contain 'overkill' (situations which are not aimed at tax avoidance do fall within the scope of the anti-abuse rule).

It should be noted that the correspondence between the definition of the classification and the objective of the measure can never be perfect. Gerards argues that for this reason the mere determination that there is a lack of precision in the definition cannot lead to the illegality of the rule. Only "a lack of care" which is unacceptable in a particular case can lead to the conclusion that the classification is unjustified. The question of whether there is a lack of care in the degree of fit between the aim of a measure and the definition of the classification varies according to the intensity of the review that is carried out. In the case

[227] Commissie Gelijke Behandeling 20 June 2007, judgment 2007-104.

[228] It should be noted that the application of the requirement of suitability may also depend on other facors that Pareto-optimality, such as the intensity of the review which a court performs in respect of a certain measure; reference is made to Gerards 2005, p 50.

[229] Alexy 2002, p 67. See also Alexy 2009, p 6.

[230] Gerards 2005, p 46.

[231] Gerards 2005, p 47.

of a marginal review, a court may be satisfied with a reasonable degree of fit, whereas the requirements for an intensive assessment may be considerably higher.[232]

Gerards has identified a number of factors which determine this level of intensity.[233] Some of these are of particular relevance for the present study. The first factor which should be mentioned is the ground of distinction. If a distinction is made on a 'suspicious' ground which is expressly mentioned in, for example, an equal treatment provision, a high level of intensity is required. This high level of intensity should be extended to distinctions which are not directly based on 'suspicious' grounds but which factually do affect the group defined by the suspicious grounds. The second factor for determining the level of intensity relates to the weight of the interests affected. The weightier the affected interest, the higher the level of intensity. Conversely, the weight of the principle which is affecting that interest can be so high that a marginal assessment should be carried out.

Subsidiarity

The requirement of subsidiarity does not so much address the way in which the classification is defined, but relates to the choice of the classification as a means of achieving the intended goal. When assessing against this criterion the question is thus primarily whether it was actually necessary to make a distinction, aside from the question as to how this distinction is actually defined.[234] Thus, the requirement of subsidiarity does not take the classification of the contested measure as a given, but requires that the court more or less independently investigates the available alternatives which are equally suitable to achieve the objective pursued. This politically more sensitive task distinguishes the over- and underinclusiveness test from the subsidiarity test.

Alexy gives an example of conflicting interests in the field of freedom of profession and consumer protection. A German regulation prohibited the sale of confection containing cocoa powder but consisting substantially of puffed rice and thus not a genuine chocolate product. The aim of this prohibition was to protect consumers from mistaken purchases. The German Constitutional Court held that the prohibition is suitable to achieve this aim but not necessary. There was an equally suitable but less interfering means available, namely a labelling requirement aimed at removing possible risks of confusion. Thus both interests involved would be satisfied without any cost for either principle but with a clear benefit for one of them (the freedom of profession). It is clear that the principle of necessity is an expression of the idea of Pareto-optimality as well: the existence of a less intensively interfering and equally suitable means; one position can be improved at no cost to the other.[235]

Alexy acknowledges that the application of the principle of necessity is more complicated in the case of a plurality of objectives.[236] The achievement of one of the objectives through the least intrusive means may have as a result that the other objective is not fully achieved. Alexy gives the example of a German rule prohibiting the business of hiring out workers

232 Gerards 2005, p 48.
233 Gerards 2005, p 84-99.
234 Gerards 2005, p 52.
235 Alexy 2002, p 398-399.
236 Alexy 2002, p 400. This is also true for the requirement of suitability.

to building contractors for a fee (a *prima facie* restriction of the freedom of profession). The aim of this prohibition was to counter abuse of *inter alia* labour law and tax law. The companies concerned argued that this aim could be achieved through a less burdensome measure: more effective supervision on building sites. The government however argued that this would be too costly and would go beyond what can reasonably be expected of society in terms of countering abuse of law. Since a prohibition and effective controls are two equally suitable means to counter abuse of law, the question is whether a high burden on public resources affects the choice for one of these alternatives. According to Alexy, this question takes us out of the field of optimization relative to what is *factually* possible, and into the greatest possible realization relative to what is *legally* possible. The question is whether the need to counter abuse of law and the protection of public resources *taken together* justify the relatively intensive interference with the freedom of profession contained in the prohibition.[237] This is a problem of balancing which should be solved in the fourth stage of the principle of proportionality to which we shall now turn.

4.5.5 Proportionality stricto sensu

After having established that a measure has a respectful objective in the light of the principle which is *prima facie* infringed and that this measure is both suitable and necessary to achieve this objective, the fourth step is to look at the result of this exercise and to assess whether ultimately a fair balance is struck between the competing interests. In case of normative classifications, a full abstract assessment can be carried out. It should be examined whether the legislator has *in abstracto* weighed the various interests against each other in a reasonable manner. If this abstract assessment leads to the conclusion that the classification is acceptable in itself, one should examine whether the application of the normative regulation *in concreto* takes sufficient account of the individual interests of the party whose *prima facie* right was affected. It may be examined whether a reasonable balance is struck between those interests and the other interests involved. In particular, it should be assessed how important a full application of the legislative act is in the concrete case at hand.[238] This assessment may lead to the conclusion that the classification which was found to be generally acceptable should provide for certain exceptions in individual cases.

As Alexy explains, this test of proportionality in the narrow sense expresses the meaning of optimization relative to competing principles. It is identical with the *Law of Balancing* which states: the greater the degree of non-satisfaction of, or detriment to, one principle, the greater must be the importance of satisfying the other.[239] Thus, the Law of Balancing makes it clear that the weight of principles can never be determined independently or absolutely, but that one can only ever speak about relative weight.[240] The very idea of a principle means that balancing is not a matter of all or nothing but a requirement to

[237] Alexy 2002, p 400-401.
[238] Gerards 2005, p 56.
[239] Alexy 2005, p 573. See also Alexy 2009, p 7.
[240] Alexy 2002, p 102.

optimize.[241] Alexian balancing of two principles can be broken down into three stages. The first stage involves establishing the degree of non-satisfaction of, or detriment to, the first principle. This is followed by a second stage in which the importance of satisfying the competing principle is established. Finally, in the third stage, it is established whether the importance of satisfying the latter principle justifies the detriment to, or non-satisfaction of, the former.[242]

Alexy emphasizes that balancing is not a procedure which necessarily leads to precisely one outcome in every case.[243] But he does maintain that one outcome can be rationally be established through the use of balancing, not in every case, but in at least some cases, and that the class of these cases is interesting enough to justify balancing as a method.[244] In order to give some more precise meaning to the concept, Alexy proposes a three-stage scale distinguishing between minor, moderate and serious infringements of a principle on the one hand, and very important, moderately important and relatively unimportant gains on the other.[245] These classifications may serve to give a quick solution in relatively easy cases of, for example, a serious infringement of principle A versus a relatively unimportant gain to principle B at the other end: the infringement is disproportionate. In case of a 'draw' – the principles involved are equally important – the decision-maker enjoys 'structural discretion'. The court will in these situations have to respect the choices which have been made by the legislature, just as it would have to respect the mirror situation in which the legislature would have given preference to the competing principle.[246]

An example from Dutch practice may clarify the requirement of proportionally in the narrow sense of the word. The example concerns a case on the taxation of tips paid to taxi drivers.[247] The taxpayer in this case had received an income tax form. The taxpayer appeared in the distribution system of tax forms because he had previously worked as a waiter and had received tips in that capacity which had not been taxed under the wage tax. The overwhelming majority of the taxi driver's colleagues did not however receive an income tax form, notwithstanding the fact that it was at the time publicly known that an average taxi driver annually receives substantial tips. As a consequence, there was an unequal treatment between the taxpayer and his fellow taxi drivers. The question arose as to whether this unequal treatment infringes the principle of equality. The *Hoge Raad* stated that the functioning of the distribution system for income tax forms reveals a certain tension between the need to ensure efficient procedures in the tax administration on the

241 Alexy 2002, p 107.

242 Alexy 2002, p 401.

243 This is an important objection to Alexy's theory: the balancing exercise would lead to arbitrary and unpredictable results (e.g. Habermas 1996, p 254 et seq.). Alexy however maintains that the balancing exercise can be performed in a rational manner; see his response to Habermas in Alexy 2002, p 401 et seq.

244 Alexy 2002, p 402.

245 Alexy 2002, p 405-406.

246 Alexy 2002, p 411-412. See elaborately on this notion Rivers 2007.

247 HR 23 October 1985, No. 23036, BNB 1986/158. The reason for providing an example form Dutch case law here instead of an example from ECJ case law is that, at this stage, the study design a model which is used to structure ECJ case law later on. Reference is made to section 8.7 for examples from ECJ case law.

one hand and the need to ensure that every person pays taxes according to the law so that no inequality arises. The *Hoge Raad* subsequently weighed these interests against each other. The mere fact that it would have been possible for the tax administration, having had regard to the information available, to issue tax forms to all taxi drivers is not enough to outweigh the need for efficiency. A factual investigation was necessary to find out whether the tax administration could not reasonably have decided to refrain from issuing tax forms to all taxi drivers with regard to administration problems. It was for the lower court to decide how big the infringement on efficiency would be. The bigger the impact, the sooner it will outweigh the principle of equality. If the tax administration could have issued tax assessments without any major efficiency problems, this small infringement of the principle of efficiency cannot outweigh the bigger infringement of the principle of equality.

4.5.6 Two concluding remarks

The above discussed four-phase structure of proportionality analysis – respectful aim, suitability, necessity and balance – illustrates, as Kumm has shown, two characteristic features of rights reasoning under Alexy's conception of rights ("rights as principles"). In the first place, having a right does not confer much on the rights holder. In other words, a *prima facie* right does not ensure the effectiveness of it in a concrete situation. An infringement of a *prima facie* right merely triggers an assessment of whether the infringement is justified. Thus it is clear that the focus of rights adjudication is generally on the reasons which justify the infringement; this is the second characteristic feature. Proportionality analysis is aimed at ensuring that the infringement of a principle is justified by "good reasons under the circumstances".[248]

4.6 The principles of good faith and systemic integration in public international law

Above I have discussed the structure of principles and the way in which competing principles should be optimized, in particular with respect to the way in which the conflict should be solved between the principle of free movement in the TFEU and the principle of direct tax sovereignty. The application of the principle of good faith in general public international law shows a striking resemblance with this discussion: the exercise in good faith of international rights and obligations. I will now explain why it is important to discuss this here.

The principle of good faith is key to the functioning of public international law. Some authors have stated that the duty to interpret and apply treaties in good faith, as laid down in Articles 26 and 31 of the VCLT, constitutes a rule of *jus cogens*.[249] The principle of good faith has found expression in Article 4(3) TEU which requires that the Member States shall take any appropriate measure to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union and that the Member

[248] Kumm 2004, p 582.
[249] Vanhamme 2001, p 39 and 58-60; Hilf 2001, p 128.

States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardize the attainment of the Union's objectives. Article 4(3) TEU requires the Member States to act in good faith to achieve the objectives of the EU law.[250] It is a special expression of the general principle of good faith which governs the exercise of competence both by the Member States and the European Union.[251]

On the international judicial level, the principle of good faith tends to transform absolute rights into relative rights in the course of a balancing process. [252] As Cheng has argued, a reasonable and *bona fide* exercise of a right is one which is "appropriate and necessary for the purpose of the right (i.e., in furtherance of the interests which the right is intended to protect)."[253] A *bona fide*, reasonable exercise of a right entails that the principle of proportionality be respected. Proportionality is a corollary of the principle of good faith.[254] The *North Atlantic Coast Fisheries Case* makes this very clear.[255] Great Britain had by treaty granted citizens of the United States the right to pursue fishery activities in its territorial waters off the coast of Canada (a British Crown colony at the time). Even though the treaty did not include any specific provision about the powers retained by Great Britain to regulate fishery activities in its territorial waters, the Permanent Court of Arbitration was asked to address the question of whether it was contrary to the treaty if such fishery regulations would restrict citizens of the United States in the exercise of the rights granted to them by the treaty. [256] The Permanent Court of Arbitration held:

> "In any event, Great Britain, as the local sovereign, has the duty of preserving and protecting the fisheries. In so far as it is necessary for that purpose, Great Britain is not only entitled, but obliged, to provide for the protection and preservation of the fisheries; always remembering that the exercise of this right of legislation is limited by the obligation to execute the Treaty in good faith."

Thus, Great Britain pursued a legitimate – or 'respectful' – objective in regulating fishery activities in its territorial waters. The Permanent Court subsequently decided and awarded as follows:

> "The right of Great Britain to make regulations without the consent of the United States, as to the exercise of the liberty to take fish referred to in Article I of the Treaty of October 20th, 1818, in the form of municipal laws, ordinances or rules of Great Britain, Canada or Newfoundland is inherent to the sovereignty of Great Britain.

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250 Balzacq, Bigo, Carrera & Guild 2006, p 3 and 11; Constantinesco 1987, p 102; Hatje 2001, p 37 and 39. Lenaerts, Van Nuffel & Bray 2005, p 115-116, are of the view that the principle of co-operation in good faith is a reflection of the principle of "federal good faith". Compare also Klabbers 2009, p 193.

251 It is perhaps for this reason that Conway 2010 examines in detail what Article 31 VCLT and the commentaries and literature thereon may mean for the conflict of norms in EU law.

252 Schwarzenberger & Brown 1976, p 35-36. Compare also O'Connor 1991, p 123-124.

253 Cheng 1953, p. 125.

254 Compare Kolb 2006, p. 8, and Andenas & Zleptnig 2007, p 375-392.

255 11 U.N.R.I.A.A. 167, 1961.

256 Engelen 2006, p. 15.

> The exercise of that right by Great Britain is, however, limited by the said Treaty in respect of the said liberties therein granted to the inhabitants of the United States in that such regulations must be made *bona fide* and must not be in violation of the said Treaty.
> Regulations which are (1) appropriate or necessary for the protection and preservation of such fisheries, or (2) desirable or necessary on grounds of public order and morals without unnecessarily interfering with the fishery itself, and in both cases equitable and fair as between local and American fishermen, and not so framed as to give unfairly an advantage to the former over the latter class, are not inconsistent with the obligation to execute the Treaty in good faith, and are therefore reasonable and not in violation of the Treaty."

These requirements brought about, *inter alia*, that light and harbour dues, if not imposed on Newfoundland fishermen, should not be imposed on American fishermen while exercising the liberty granted by the Treaty:

> "To impose such dues on American fishermen only would constitute an unfair discrimination between [American fishermen] and Newfoundland fishermen and one inconsistent with the liberty granted to American fishermen to take fish, etc., in common with the subjects of His Britannic Majesty".

In abstract terms, in the words of Engelen, the limit of the powers retained by Great Britain to regulate fishery activities in its territorial waters is where it can no longer be said that the treaty obligations have been performed in good faith, whilst the limit of these obligations themselves is defined in terms of what is reasonably necessary for achieving the legitimate objectives pursued by such fishery regulations, because otherwise, the powers retained would be devoid of any substance.[257] This makes it clear that the four phases of the proportionality test (see section 4.5 above) – respectful aim, suitability, necessity and balance – are supported by the principle of good faith. In my view, at least, this inevitably follows from the quotation from the *North Atlantic Coast Fisheries Case* above.

The WTO Appellate Body seems to have confirmed this view in 1998 in the *Shrimp-Turtle* case when, speaking of good faith, it quoted Cheng in assent:

> "A reasonable and *bona fide* exercise of a right (…) is one which is appropriate and necessary for the purpose of the right (i.e., in furtherance of the interests which the right is intended to protect). It should at the same time be fair and equitable as between the parties and not one which is calculated to procure for one of them an unfair advantage in the light of the obligation assumed. A reasonable exercise of the right is regarded as compatible with the obligation. But the exercise of the right in such a manner as to prejudice the interests of the other contracting party arising out of the treaty is unreasonable and is considered as inconsistent with the *bona fide* execution of the treaty obligation, and a breach of the treaty."[258]

[257] Engelen 2006, p. 15.
[258] Appellate Body World Trade Organization 12 October 1998, Shrimp-Turtle Case, No. 98-3899,

Hilf has concluded from this judgment that it is for the principle of proportionality to balance such conflicting interests in the light of the further legal requirements as listed in the chapeau of Article XX of the GATT 1994. Trade measures of the WTO Members, designed to follow a legitimate non-economic interest, should be 'effective', necessary', and 'reasonable', thus referring to the classical three requirements of the principle of proportionality.[259] Appleton has drawn a similar conclusion. In his opinion the Appellate Body requires that the rights and obligations of the Members are exercised in good faith ('reasonably'), which necessarily leads to the adoption of some sort of proportionality inquiry.[260] Similarly, Van Aaken has taken the position – referring to the Israeli Supreme Court – that proportionality is recognized today as a general principle of international law.[261]

The already-mentioned *Shrimp-Turtle* case reveals very clearly that the principle of good faith can play an important role in the resolution of normative conflicts. The case concerned a US import ban on shrimp harvested without approved "turtle excluder devices" which would prevent turtles being caught in the nets used for shrimps. The conflict between the objective of general elimination of quantitative restrictions between the WTO Member States (see Article XI GATT) and the competence to take measures which are necessary to protect the environment (Article XX GATT) is obvious. The Appellate Body of the WTO dealt with this conflict under the principle of good faith.[262] It held that Article XX embodies the recognition on the part of WTO Members of the need to maintain a balance of rights and obligations between the right of a Member to invoke one or another of the exceptions of Article XX, such as the protection of the environment, on the one hand, and the substantive rights of the other Members under the GATT 1994, on the other hand. Exercise by one Member of its right to invoke an exception, if abused or misused, will, to that extent, erode or render naught the substantive treaty rights in, for example, Article XI, of other Members. Similarly, in recognition of the legitimate nature of the policies and interests embodied in Article XX, the right to invoke one of those exceptions is not to be rendered illusory. Thus,

> "a balance must be struck between the *right* of a Member to invoke an exception under Article XX and the *duty* of that same Member to respect the treaty rights of the other Members. To permit one Member to abuse or misuse its right to invoke an exception would be effectively to allow that Member to degrade its own treaty obligations as well as to devalue the treaty rights of other Members. If the abuse or misuse is sufficiently grave or extensive, the Member, in effect, reduces its treaty obligation to a merely facultative one and dissolves its juridical character, and, in so doing, negates altogether the treaty rights of other Members."

§ 158 footnote 156 (citing Cheng 1953, p 125).

259 Hilf 2001, p 128.

260 Appleton 1999, p 492.

261 Van Aaken 2009, p 502.

262 WTO Appellate Body 12 October 1998, Shrimp-Turtle Case, No. 98-3899, § 156-159.

The WTO Appellate Body subsequently considered that Article XX is, in fact, but one expression of the principle of good faith which controls the exercise of rights by States. One application of this general principle, the Appellate Body observes, is the application widely known as the doctrine of *abus de droit* which prohibits the abusive exercise of a State's rights and enjoins that whenever the assertion of a right impinges on the field covered by a treaty obligation, it must be exercised *bona fide*, that is to say, reasonably. An abusive exercise by a Member of its own treaty right thus results in a breach of the treaty rights of the other Members and, as well, a violation of the treaty obligation of the Member so acting. The task of the Appellate Body is, hence, essentially to locate and to mark out:

> "a line of equilibrium between the right of a Member to invoke an exception under Article XX and the rights of the other Members under varying substantive provisions (e.g. Article XI) of the GATT 1994, so that neither of the competing rights will cancel out the other and thereby distort and nullify or impair the balance of rights and obligations constructed by the Members themselves in that Agreement. The location of the line of equilibrium (…) is not fixed and unchanging; the line moves as the kind and the shape of the measures at stake vary and as the facts making up specific cases differ."

These considerations make it very clear that the principle of good faith requires that a State which exercises rights in the sphere of a treaty obligation strikes a fair balance between the rights which it has retained and the obligations which it has accepted by signing on to the treaty. An equilibrium should be struck between the right and obligation in such a way that neither of the two will cancel out the other and thereby distort and nullify or impair the balance of rights and obligations constructed by the contracting parties to the treaty (compare the requirement of a 'respectful aim' discussed in section 4.5.2).

Thus, the principle of good faith has a very important role to play in the application of rules and principles of international law. It does not seem to differ substantially from Alexy's theory of constitutional rights.[263] Van Aaken also places Alexy's theory in the context of Article 31(3)(c) VCLT which provides that the interpretation of a treaty shall take into account, together with the context, any relevant rules of international law applicable in the relations between the parties.[264] As a part of the VCLT rules on treaty interpretation – Articles 31 to 33 VCLT – this provision fully reflects customary international law and follows from the principle of good faith.[265] It has recently been taken up by the International Law Commission and its Study Group on Fragmentation of International Law has prepared a report on this topic. According to the Study Group, Article 31(3)(c) VCLT may be taken to express what may be called the principle of "systemic integration", whereby international obligations are interpreted by reference to their normative environment ("system").[266] The rationale for such a principle is understandable:

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[263] Compare Andenas & Zleptnig 2007. Similarly Petersen 2008, p 291.

[264] Van Aaken 2009, p 512.

[265] Case concerning Kasikili/Sedudu Island (Botswana/Namibia), ICJ Reports 1999, p. 1059, paragraph 18; Engelen 2004, pp. 54-56 and p 251 and the case law there referred to.

[266] International Law Commission, 58th session, nr. A/CN.4/L.682, p 208, § 413.

> "All treaty provisions receive their force and validity from general law, and set up rights and obligations that exist alongside rights and obligations established by other treaty provisions and rules of customary international law. None of such rights or obligations has any *intrinsic* priority against the others. The question of their relationship can only be approached through a process of reasoning that makes them appear as parts of some coherent and meaningful whole."[267]

As McLachlan argues, the principle of systemic integration may be articulated as a presumption with both positive and negative aspects:

> (a) *negatively* that, in entering into treaty obligations, the parties intend not to act inconsistently with generally recognized principles of international law or with previous treaty obligations towards third states; and
> (b) *positively* that the parties are to be taken to refer to such principles for all questions which the treaty does not itself resolve expressly and in a different way.[268]

McLachlan further explains that the significance of such rules is that they perform a systemic or constitutional function in describing the operation of the international legal order. The principle of systemic integration furnishes the interpreter with a master key which enables him to find an appropriate accommodation between conflicting values and interests in international society.[269] As Van Aaken has put it:

> "Systemic integration can be achieved through interpretation mainly through Article 31(3)(c) of the Vienna Convention. But the Vienna Convention tells us only which other international law can be considered when adjudicating. It does not tell us how to do it. The principle of proportionality, as a meta-principle of international law, is the most probable candidate for integration. It considers conflicting principles and harmonizes them through balancing.
> The legal theoretical background of doing so has been elaborated by Robert Alexy. This allows for the consideration of other areas of PIL and helps to defragment PIL."[270]

The conclusion that the general public international law principle of good faith and Article 31(3)(c) VCLT support Alexy's theory of constitutional rights is important for this part of the present study, the aim of which is to formulate a theoretical assessment model for the optimization of two principles of international law: direct tax sovereignty and EU free movement. The above-discussed case law and literature shows that this optimization is performed in general public international law by application of the principle of

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267 International Law Commission, 58th session, nr. A/CN.4/L.682, p 208, § 414.
268 McLachlan 2005, p 311, with further references.
269 McLachlan 2005, p 318. See for a similar statement International Law Commission, 58th session, nr. A/CN.4/L.682, p 234, § 465. Compare also Sands 1998, p 95.
270 Van Aaken 2009, p 512.

proportionality through which an equilibrium is struck between the right and obligation in such a way that neither of the two will cancel out the other: a process of systemic integration.

4.7 Conclusion

This chapter has been dedicated to an extensive summary and analysis of Robert Alexy's theory of principles, because this theory is able to provide a theoretical framework for resolving the conflict between national direct tax sovereignty and EU free movement (see chapter 3 and section 4.1 for an account of the choice for Alexy's theory).[271] Although Alexy has written his work in a German constitutional context, the argument he makes is of universal application. Alexy's theory will be applied to this conflict in chapter 7, after the competing principles have been restated in chapters 5 and 6.

Alexy divides norms into rules and principles (section 4.2). A principle is an open norm, the scope of which depends on its application in a certain legal environment. By contrast, a rule is a closed norm, the scope of which has already been determined by the authority which has passed it. *Principles* are norms which require that something be realized to the greatest extent possible given the legal and factual environment. They are *optimization requirements*, characterized by the fact that they can be satisfied to varying degrees. By contrast, *rules* are norms which are always either fulfilled or not. Thus, principles are always *prima facie* reasons and rules are *definitive* reasons. Typically, a principle itself is not capable of determining its own extent in the light of competing principles and what is factually possible. In case of a conflict between a rule and a principle, the principle may require that an exception be added to the rule in certain circumstances. Thus, both rules and principles may appear only *prima facie* (section 4.2). Their *prima facie* character, however, may be fundamentally different due to 'formal principles' which may require that rules passed by an authority acting within its jurisdiction are to be followed. Since these formal principles do not apply if a tax measure is tested against the EU free movement provisions, national tax rules – which are an emanation of the principle of sovereignty – and EU principles have the same *prima facie* character.

The nature of a principle as an optimization requirement demands that a maximally wide scope of its protected interests be adopted (section 4.3). Alexy rejects any form of threshold which would have to be met before it can be said that a certain principle *prima facie* competes with another principle. The adoption of the widest possible scope of a principle enables the courts to optimize all relevant principles involved, without the risk of not meeting a certain threshold. This means, in relation to the EU free movement provisions, that every tax obstacle – this term will be explained in detail in chapter 6 – *prima facie* infringes the principle of free movement.

As principles require a maximally extensive protection of interests, the limitation of a protected interest is always a limitation of the *prima facie* position of a principle (see section 4.4). All norms which are *compatible with the Constitution* – or in a European context: the TEU and the TFEU – are capable of being a limit to a principle. No additional

[271] The account given in this conclusion does not refer to specific sources, because it is a summary of chapter 4. Reference is made to the specific paragraphs for acknowledgements.

requirements, such as a certain weight of the norm before it can serve as a limit, need to be met. This means that in current ECJ case law the formal requirement could be dropped that only 'compelling' or 'overriding' reasons in the general interest can serve as a limit to the principle of free movement.

Rules and principles which limit the realization of a principle can be divided into three different types. Commanding and prohibiting norms have by definition a limiting character, so that they come within the scope of the principle limited by them. A different approach applies to formative powers. The creation of (private law) powers *as such* has no limiting character. Its removal would however have a limiting character if it obstructs the realization of a principle. According to Alexy it is of fundamental importance to distinguish between rules and principles in the context of the mechanism of limitation. A *rule* limits a constitutional right when, if it is applicable, a definitive no-liberty or no-right of the same content applies in place of a constitutional *prima facie* liberty or right. A *principle* can also act as a limit to another principle, but the mechanism is different. The extent to which principles limit another principle is not clear from the start – this is the case with limiting rules – but becomes apparent only after a balancing exercise.

The fact that principles are to be realized to the greatest extent possible given empirical and normative constraints implies the principle of proportionality with its three sub-tests of suitability, necessity (use of the least restrictive means), and proportionality in its narrow sense (that is, the balancing requirement). According to Alexy, this logically follows from the nature of principles; it can be deduced from them (section 4.5.1). The test of *proportionality in its narrow sense*, that is, the requirement of balancing, derives from its relation to the *legally* possible. The tests of necessity and suitability follow from the nature of principles as optimization requirements relative to what is *factually* possible. Thus, the latter tests take the aim of the tested rule or principle against another principle as a given, whereas the former test may, wholly or partially, set aside that aim.

Alexy does not require that the norm limiting a principle has a 'legitimate aim', that is, he is not using this terminology. The only 'absolute' requirement of a limit would be that it is compatible with the Constitution. The question of whether the restricted principle has a greater weight than the principle underlying the limit should be answered solely within the framework of the last phase of the proportionality test (proportionality in the narrow sense or the balancing requirement).

Section 4.5.2 of the present study argues that a 'respectful ends' test is implicit in Alexy's theory. The definition of this test has been developed as follows: a limit to a restricted principle does not have a respectful aim if it has no other objective than limiting that principle. Also, a restricted principle does not have a respectful aim if it does not accept that it may be limited. In both cases, the principle and the limit do not 'respect' each other. In my view, no other requirements may be imposed, apart from being formally and substantively compatible with other principles with a similar status, such as the prohibition of State aid in Articles 107 and 108 TFEU. The introduction of a 'respectful ends' test is based on the fact that principles can never be absolute. This means that neither the restricted principle nor its limit can be absolute in the sense that they can never be outweighed. It should always be possible to perform a balancing exercise, and insofar as one of the principles regards itself as inviolable this is impossible. A principle which does not recognize other principles cannot engage in balancing with another principle. In addition, a principle itself

is not capable of determining its own extent in the light of competing principles and what is factually possible. This extent is determined by proportionality analysis (suitability, necessity and balance), which should be able to be performed. This means that neither the extent of the restricted principle nor the extent of its limit can be determined in advance by reference to that principle or that limit. Principles and limits which are nevertheless characterized by the wish to determine their own extent and, consequently, to disregard other principles, cannot be qualified as principles or limits because such a qualification would be 'disrespectful' towards other principles. In other words, the goal of a limit to a principle should be external to the goal of being a limit. Conversely, the restricted principle should accept *in abstracto* the possibility of being limited. This means, for instance, that budgetary reasons can never justify an infringement which a tax measure imposes on a competing principle. If it were otherwise, the extent of tax sovereignty would be unlimited and absolute: it would not accept other principles as limits.

The definition of a 'respectful aim' places a very high emphasis on the objective of a limit to a principle which may be difficult to determine. At least two difficulties may arise when assessing the aim of a measure. Firstly, it may be difficult to discover which aim exactly underlies a certain rule. This is a problem every court is familiar with; it should be solved through the normal rules of interpretation. Secondly, a rule may pursue various aims at the same time: a plurality of objectives. If one of the aims is 'legitimate' – or in my terminology 'respectful' – but the other is not, the question arises of whether the rule is acceptable or not. Gerards distinguishes two situations: a provision may pursue different objectives with a similar value, but it is also possible that the aims are of differing weight. In the latter situation the main objective may be rather general, such as ensuring public safety. Its sub-objectives are then subsidiary to the main goal. I agree with Gerards that the courts should investigate, on a case-by-case basis, whether the measure would also be justified if the unacceptable goal were eliminated.

The test of suitability is of an empirical nature (see section 4.5.3). It entails an optimization requirement relative to what is factually possible (as opposed to what is legally possible). The test of suitability takes the respectful aim as a given and examines whether the rule at issue is apt to attain the objectives pursued. According to Alexy, the test of suitability is none other than an expression of the idea of Pareto-optimality: one position can be improved without detriment to another.

The test of necessity derives from the very nature of principles, just as the principle of suitability (see section 4.5.4). It requires that of two broadly equally suitable means, the one which interferes less intensively should be chosen. Thus it entails an optimization requirement relative to what is factually possible. As such it is an expression of the idea of Pareto-optimality as well. The necessity test can be divided into two sub-tests: a test which examines the degree of fit of a measure and a test which examines the subsidiarity of a measure. The first test examines whether the classification is sufficiently fine-tuned in relation to its objective. The subsidiarity test, which is politically more sensitive, examines whether another classification should have been chosen to achieve the objective of the measure; this requires that the court itself examines which alternative measures would have been available. Alexy acknowledges that the application of the necessity test is more complicated in the case of a plurality of objectives. The achievement of one of the objectives through the least intrusive means may have as a result that the other objective is not fully achieved.

The test of proportionality in the narrow sense expresses the meaning of optimization relative to competing principles (section 4.5.5). It is identical with the *Law of Balancing* which states: the greater the degree of non-satisfaction of, or detriment to, one principle, the greater must be the importance of satisfying the other. This reflects a requirement to optimize. Balancing can be broken down into three stages. Alexy shows that the first stage involves establishing the degree of non-satisfaction of, or detriment to, the first principle. This is followed by a second stage in which the importance of satisfying the competing principle is established. Finally, in the third stage, it is established whether the importance of satisfying the latter principle justifies the detriment to, or non-satisfaction of, the former. In order to give some more precise meaning to the concept, Alexy proposes a three-stage scale distinguishing between minor, moderate and serious infringements of a principle on the one hand, and very important, moderately important and relatively unimportant gains on the other. Alexy's classifications may serve to provide a quick solution in relatively easy cases of, for example, a serious infringement of a principle versus a relatively unimportant gain to another principle at the other end: the infringement is disproportionate. In case of a 'draw' – the principles involved are equally important – the decision-maker enjoys 'structural discretion'. The court will in these situations have to respect the choices which have been made by the legislature, just as it would have to respect the mirror situation in which the legislature would have given preference to the competing principle.

It has been argued in section 4.6 that the general public international law principle of good faith and Article 31(3)(c) VCLT support Alexy's theory of constitutional rights. The case law and literature discussed there shows that optimization of competing international rights and obligations should be performed by application of the principle of proportionality through which an equilibrium is struck between the right and obligation in such a way that neither of the two will cancel out the other: a process of systemic integration. The four above-described phases of proportionality analysis should be applied where a State exercise rights on the international level which *prima facie* interfere with rights of other States.

We will now apply Alexy's theory of principles to this conflict. Chapters 5 and 6 will explain their *prima facie* position and chapter 7 will provide for a theoretical optimization model through which both principles can be optimized.

5. The principle of direct tax sovereignty

5.1 Sovereignty as a principle

Although much criticized, the principle of sovereignty is still very central to almost all thinking about international law.[272] As Jeffery has noted, sovereignty refers to the bundle of rights and competences which go to make up the nation State, as a consequence of which it can be equated with Statehood. Jurisdiction refers to particular rights of the bundle of rights which comprise Statehood. It refers to a State's right of regulation in its judicial, administrative, and legislative competence.[273] Because jurisdiction is a corollary of sovereignty, the jurisdiction of a State cannot extend further than its sovereignty. Isenbaert, who has done impressive research on the notions of sovereignty and of income tax sovereignty, has stated that the essence of the sovereignty concept is reflected by the establishment and justification of a claim to supreme authority within a particular body politic;[274] it is a claim to "ultimate, and thus exclusive, authority.[275] Of course, States are always free to limit their jurisdiction unilaterally or by means of a treaty.[276] This proves that even today the sovereign State remains the principal actor in the international arena.[277] In the words of Isenbaert:

> "As a consequence of the ever-growing body of international law and the resulting binding international obligations, the sovereign state has turned into an organization that can no longer be considered as the sole wielder of all political authority. Even in this situation of multilateral obligations, the state is seen as exercising its sovereignty through concluding international treaties or becoming a member of a supranational organization in order to transform the functions and objectives of its sovereign powers into different or more advanced functions and objectives of the international treaty or the supranational organization. By those means, the exercise of the state of its sovereign powers gains a new functionality. Hence, it can be said that external sovereignty has become a *concept of functional freedom for the states*, through which they can alter and enhance the functions of their sovereign power and the level on which these functions are exercised."[278]

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272 Jackson 2006, p. 57.
273 Jeffery 1999, p. 26, with further references.
274 Isenbaert 2010, p 62.
275 Isenbaert 2010, p 72.
276 Vanhamme 2001, p 52.
277 Isenbaert 2010, p 66.
278 Isenbaert 2010, p. 67. Italics by the present author.

Also according to the *Lotus* principle, any attempt to constrain the State's *freedom of action* in the absence of a legal prohibition is a violation of State sovereignty.[279] Thus, in the present author's view, sovereignty should be understood as a *prima facie* general freedom of action of States, as limited by international law.[280]

Sovereignty is also quite central to the concept of equality of nations. Sovereignty presumes that there is no higher power than the nation State and negates the idea that there is a higher power, internationally or foreign (unless consented to by the nation State).[281] According to Jeffery, the sovereign nature of jurisdiction means that it is linked to the principle of the equality of nation States, which together with sovereignty, has been described as 'the basic constitutional doctrine of the law of nations'.[282] Since every State enjoys the same degree of sovereignty, jurisdiction implies respect for the corresponding rights of other States.[283] This means that sovereignty can never be absolute.[284] It represents an aspiration rather than a concrete stipulation. The extent of a State's sovereignty can be determined only if it is confronted with the sovereignty of other States or other principles or rules of international law.

The question arises whether new supranational levels of authority can be said to have acquired sovereignty in their own right and, if so, what the relationship is between those new levels of authority and the sovereignty of the individual nation States. Isenbaert has discussed a number of different views in literature on this issue. First, there is the approach which considers sovereignty as something which can be delegated. This approach denies that supranational organizations would have any sovereignty of their own.[285] A second approach considers sovereignty to be something which can be divided between States and supranational organizations.[286] Thirdly, there is the idea which focuses on 'function-sovereignty' or 'constitutional pluralism'. The essence of constitutional pluralism is that two (or more) parallel and equivalent legal claims to ultimate authority are made by two (or more) sovereign entities situated at different levels.[287] According to Isenbaert, however, the idea that two more or less similar sovereign claims are made at the same time is unsatisfactory, because it results in a clash between those claims. A better approach would be to acknowledge that a part of the sovereign functions and objectives of the State are brought to and transformed by the supranational level by instating a supranational body,

279 S.S. Lotus, 1927 P.C.I.J. (ser. A) No. 10 (Sept. 7) (formulating the background assumption in intemational law that a state is constrained only by rules to which it has consented). See Petersen 2008, p. 303.

280 Bernhardt 1985, p. 410. Jeffery 1999, p 30-31, is critical about this so-called 'positivist' view of State freedom of action. In his view, the better approach is the one that requires a party to establish a particular ground of jurisdiction and not just to show that it is not prohibited. For purposes of the present study the difference between these two approaches is not that relevant, because in both approaches sovereignty would be regarded as a principle in Alexy's sense.

281 Jackson 2006, p. 58.

282 Jeffery 1999, p. 26.

283 Mann 1990, p. 4, quoted by Jeffery 1999, p. 27.

284 Compare Isenbaert 2010, p 49-50 and p 54-55.

285 Isenbaert, p 68-69.

286 Isenbaert, p 70-71.

287 Isenbaert, p 72.

the existence of which is confined to the functions and objectives of the supranational level (an internal functional boundary, e.g. a certain policy area) and geographically restricted by the territory of the Member States (a geographical boundary). Isenbaert calls this function-sovereignty.[288] Isenbaert stresses that function-sovereignty over a certain policy area does not entitle the body politic concerned to absolute or exclusive *competence* within that area, because the body politic must be cautious as not to render impossible the performance of the functions and the pursuit of the objectives of policy areas over which the other body politic is function-sovereign.[289] The circumstance that the sovereignty of a certain body is limited not only by geographical boundaries but also by functional boundaries, raises the question to what extent such a body is competent to determine its own competence (*Kompetenz-Kompetentz*). In this regard, Isenbaert distinguishes legislative competence-competence and judicial competence-competence. Through the first competence, the body in question would be able to expand its competence, whereas this would occur less frequently with respect to the second competence.[290] The issue of judicial competence-competence is however very much debated in the area of free movement and direct taxation (see chapter 2 of the present study).

The considerations above indicate that sovereignty has to be regarded as a principle rather than as a rule of international law: it is regarded as a *prima facie* general freedom of action by States which is not absolute but relative and the extent of which cannot be determined in isolation.[291] Indeed, Alexy's doctrine of collision – see section 4.2 – would identify sovereignty as a principle. A conflict between a State's sovereignty and the sovereignty of another State or between the functions of a State and a supranational body is not solved by declaring one of these invalid or by placing one of them outside the legal order, but by giving precedence to one of them under particular circumstances; the sovereignty of one State cannot annul the sovereignty of another State of supranational body. This exercise takes place within the legal order, which is shown by the fact that the result may be different if the circumstances change. A good example is provided by the Separate Opinion of Judge Wellington Koo in the *Right of Passage over Indian Territory Case* before the International Court of Justice.[292] This case concerned the accessibility of Portuguese enclaves on Indian Territory. The opinion of Wellington Koo contains interesting elaborations on the reconciliation of Portuguese and Indian sovereignty and the potential value of the principle of good faith in reconciling the co-existence of two legal rights.[293] Wellington Koo notes that the right of passage has two concurrent features: on the one hand, it is necessary for the exercise of Portuguese sovereignty over the enclaves, and, on the other hand, its exercise is subject to control and regulation of India insofar as the passage takes place over the intervening Indian territory. This means that with the right on each side there also exists an obligation – that of India to accord passage and that of Portugal to respect the rules of procedure respecting the application for, and

[288] Isenbaert 2010, p 72-73.
[289] Isenbaert, p 75-76.
[290] Isenbaert, p 77-78.
[291] Compare Isenbaert 2010, p 5-6 and p 56-57 with further refrences.
[292] ICJ 12 April 1960, *Right of Passage over Indian Territory Case*, ICJ Reports 1960, p 6.
[293] O'Connor 1991, p. 122.

grant of, passage. In other words, the rights and obligations of both sides are concomitant and correlative. This does not mean, however, that they are not reconcilable with each other. According to Wellington Koo, neither Portuguese sovereignty over the enclaves nor Indian sovereignty over its territory can be regarded as an absolute, unrestricted right. An obligation rests on both States to strike a fair balance between the conflicting interests in accordance with the principle of good faith which States have to take into account when pursuing their own national interests. A similar approach is followed by the case law and literature discussed in section 4.6. Therefore, Noll has rightly argued that, under Alexy's theory, sovereignty is to be framed as a principle and not as a rule in international law. The conflict between sovereignty and competing principles may be solved by weighing them against each other under Alexy's theory of principles.[294]

Before an optimization model can be provided for that purpose in chapter 7, the *prima facie* position of direct tax sovereignty – a general freedom of action of States – should be elaborated a little further. According to Brownlie, the principal corollaries of the sovereignty and equality of States are: 1) a jurisdiction, *prima facie* exclusive, over a territory and the permanent population living there; 2) a duty of non-intervention in the area of exclusive jurisdiction of other States; and 3) the dependence of obligations arising from customary law and treaties on the consent of the obligor.[295] With regard to EU law, Isenbaert has indeed concluded that direct taxation as a policy area has remained part of the function-sovereignty of the Member States. This means that the Member States are able to pursue the core functions and essential objectives of that policy area, which is the essence of function-sovereignty.[296] The three most important aspects of direct tax sovereignty include i) the freedom for a State to determine within its domestic jurisdiction the organization and objectives of the tax system; ii) the obligation for a State to respect the direct tax sovereignty of other States; and iii) the fact that a State's tax jurisdiction is limited by customary international law and bilateral tax treaties. These three aspects are now discussed.

5.2 Direct tax jurisdiction

It should be noted at the outset that a short overview of a State's tax jurisdiction has already been provided in section 2.2.2. Although the overview given in section 5.2 is more comprehensive, there are overlaps between the two sections. With a view to service to the reader, I have decided not to cross-refer but to include the whole comprehensive account in section 5.2. Readers who are familiar with the concept of direct tax jurisdiction may skip section 5.2 and go directly to section 5.3.[297]

[294] Noll 1997, p 339-441. Verschuuren has also argued that sovereignty should be seen as a principle and not as a rule; see Verschuuren 2006, p 39.

[295] Brownlie 2003, p. 287.

[296] Isenbaert 2010, p 223.

[297] Persons who would like to read more on the subject are referred to Monsenego 2011, p 57-102, for an insightful overview.

5.2.1 Legislative jurisdiction under customary international law

Territorial and personal bases of jurisdiction

The traditional approach of establishing jurisdiction is founded on the territorial and personal bases of jurisdiction. As Jeffery has demonstrated, the fundamental jurisdictional connection is the territorial basis that refers to jurisdiction over persons, matters and things within the geographical boundaries of a State.[298] In relation to fiscal jurisdiction, this is illustrated by the taxation of income with its source, or a person residing, within the territory.[299] The other jurisdictional connection is personal, based on the nationality or domicile of a person as the connecting factor.

The personal basis of jurisdiction: nationality

Nationality is widely accepted as a valid jurisdictional basis for the assertion of a State's jurisdiction over persons. A person with the nationality of the taxing State can be liable to be taxed on his full, worldwide assets and income, from whatever source.[300] Consequently, a State has unlimited fiscal jurisdiction over its nationals. International law leaves it to a State to decide who are its nationals.[301] According to Jeffery, the incorporation of a company in a State is analogous to nationality with regard to persons, so that this is also a basis for unlimited fiscal jurisdiction.[302]

The territorial basis of jurisdiction

The principle of fiscal territoriality refers to jurisdiction over persons, matters and things within the geographical boundaries of a State. A State may tax a person residing in its territory or income arising there. The scope of jurisdiction of persons or income is by its nature different.

A State has *unlimited fiscal jurisdiction* over individuals and companies *residing* within its territory. Consequently, a State is competent to tax the worldwide income of those individuals and companies. Customary international law leaves it to States to determine who their residents are, including the nature and extent of presence within the territory that is required.[303] The concept of residence does, however, make it clear that a more permanent nature of contact is required to establish worldwide jurisdiction. As Martha has pointed out, fiscal jurisdiction on the basis of residence is, in the view of general international law, only relevant with regard to aliens.[304]

A State may tax non-resident aliens, individuals and companies, but only with regard to the particular sources of income within its territory. Accordingly, the fiscal jurisdiction of a State in respect of *non-resident aliens* is *limited* to the sources of income within the State.[305]

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298 Jeffery 1999, p. 44.
299 Compare Case C-451/99 *Cura Anlagen*, § 40.
300 Martha 1989, p. 48.
301 Jeffery 1999, p. 49.
302 Jeffery 1999, p. 49.
303 Jeffery 1999, p. 45.
304 Martha 1989, p. 50-51.
305 Martha 1989, p. 54.

Thus, the jurisdictional principle of fiscal territoriality includes unlimited fiscal jurisdiction with regard to resident aliens and limited fiscal jurisdiction in respect of non-resident aliens.

Implied limitations on jurisdiction to tax
The jurisdictional principles to tax referred to in the previous paragraphs may also be formulated negatively. A State may tax a foreign company with no headquarters in the State and carrying on business in the State on the income derived from that business, but not on its worldwide income. A State may also tax persons who are not nationals or residents of the State with regard to income derived from property in the State, but the property and income do not justify the taxation of property or income outside the State.[306] The American Law Institute has taken the position that the jurisdiction to tax nationals and residents implies that a State may tax a parent corporation on its worldwide income, including that of its branches and subsidiaries.[307]

5.2.2 Allocation of jurisdiction in tax treaties

It is clear from the outset that the application of the rules of customary international law with regard to fiscal jurisdiction may lead to international juridical double taxation. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.[308] According to the Commentary to the OECD Model Tax Convention, the harmful effects on the exchange of goods and services and movements of capital and persons are so well known that it is unnecessary to stress the importance of removing the obstacles that double taxation presents for the development of economic relations between countries. The primary purpose of the OECD Model is to provide a way of settling on a uniform basis the most common problems in respect of international juridical double taxation. Most tax treaties are, to a large extent, based on the OECD Model. The Introduction to the OECD Model explains that it establishes two categories of rules for the purpose of eliminating double taxation. "First, Articles 6 to 21 determine, with regard to different classes of income, the respective rights to tax of the State of source or *situs* and of the State of residence, and Article 22 does the same with regard to capital. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence. In the case of other items of income and capital, the right to tax is not an exclusive one. As regards two classes of income (dividends and interest), although both States are given the right to tax, the amount of tax that may be imposed in the State of source is limited. Second, insofar as these provisions confer on the State of source or *situs* a full or limited right to tax, the State of residence must allow relief so as to avoid double taxation; this is the purpose of Article 23 A and 23 B. The

306 Restatement of the Law, Third, 1987, § 412(a).
307 Restatement of the Law, Third, 1987, § 412(e).
308 Commentary to the OECD Model, Introduction, § 1.

Convention leaves it to the Contracting States to choose between two methods of relief, i.e. the exemption method and the credit method."[309] Consequently, the first category of rules allocates the jurisdiction to tax. The second relates to the method by which double taxation is eliminated. There are basically two methods of relief, i.e. the exemption method and the credit method.

5.2.3 Self-imposed unilateral limitations on jurisdiction

Many States have imposed unilateral limitations on the exercise of jurisdiction. For example, most States do not fully apply their worldwide jurisdiction on the basis of nationality.[310] With regard to the taxation of income, the Netherlands, for instance, only applies the personal basis for jurisdiction (the nationality of the taxpayer) to companies.[311] France operates a territorial system for corporate income tax purposes. In principle, account is only taken of profits realized in undertakings operating in France or in those liable to taxation in France by virtue of a tax treaty.[312] Consequently, France does not make use of its unlimited fiscal jurisdiction with regard to companies incorporated under French law and those resident in France. Instead, France applies a strict territoriality principle for the taxation of company profits.

5.2.4 Consequences of the overlaps and limitations of direct tax jurisdiction

Introduction
The outline of a State's direct tax jurisdiction shows that tax jurisdictions may overlap and that a tax jurisdiction is necessarily limited in scope. The consequences of that have been subject to extensive ECJ case law (see section 2.2.4). The purpose of the present section is not to discuss this case law, but to clarify the consequences apart from any case law. Chapter 8 will discuss how the ECJ should have dealt with these consequences in relation to EU free movement under the theoretical optimization model outlined in chapter 7.

Overlap of direct tax jurisdictions
The co-existence of discrete national fiscal jurisdictions leads to international juridical double taxation. After all, the application of the rules of customary international law with regard to fiscal jurisdiction – nationality, residence and source – may lead to an overlap. Three concurrences of bases of jurisdiction may typically arise.[313]

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309 Commentary to the OECD Model, Introduction, § 19.

310 An exception is the United States, which, in principle, taxes its nationals on their worldwide income.

311 Although the principle of nationality also plays a minor role with regard to individuals; in particular, in respect of diplomatic staff (Art. 2.2 of the Individual Income Tax Law (*Wet inkomstenbelasting* 2001)). For the worldwide jurisdiction with regard to companies incorporated under Netherlands law, see Art. 2(4) of the Corporate Income Tax Law (*Wet op de vennootschapsbelasting* 1969).

312 Art. 219 General Tax Code (*Code Général des Impôts* (*Territorialité de l'impôt sur les sociétés*)).

313 Van Raad (loose-leaf), 1.2.2. See also Bender 2000, p 16-25.

1. Concurrence of subject and object related bases of jurisdiction. The most frequently seen concurrence is a simultaneous exercise of jurisdiction by two States based on residence and source respectively. As Van Raad shows, two main items of income should be distinguished.[314] In the first place, there is the category of dividends and interest and royalty payments. The source State may want to impose a withholding tax on such a dividend, whereas the State of residence (or nationality) taxes the recipient of the income on his worldwide income. Under tax treaties, many residence States would grant an ordinary credit for the foreign withholding tax (the withholding tax levied on the payment maximized by the domestic taxation attributable to it). In the second place, there is income from foreign real property, a foreign business (permanent establishment), dependent services and similar 'active' income. Normally, the source State will tax this income, whereas the State of residence (or nationality) also taxes the recipient of the income. Under tax treaties, many residence States would grant an exemption of this foreign income.

2. Concurrence of two subject related bases of jurisdiction. Three different situations should be distinguished here.[315] In the first place, jurisdiction based on residence and nationality respectively may lead to an overlap of jurisdiction. This may occur, for example, in respect of a company incorporated under Netherlands law of which the effective management in situated in another State. In this situation two States will tax the Dutch company on its worldwide income: the Netherlands on the basis of the 'nationality' of the company and the other State on the basis of its residence there. In the second place it is possible that two States will simultaneously treat a person as a resident taxpayer (worldwide taxation). In the third place, a taxpayer may have a double nationality, as a result of which he may be subject to worldwide taxation in both States.

3. Concurrence of two object related bases of jurisdiction. This situation occurs if a person is subject to limited taxation in a source State on income which has arisen in a third State. Van Raad gives the example of profits attributable to a permanent establishment, where interest payments from a third State are included in that profit. The third State may have imposed a withholding tax on the interest payment, whereas the source State also taxes the interest.[316]

Limitation of direct tax jurisdictions by customary international law

The fact that national tax systems are necessarily limited in geographical and personal scope has two consequences. In the first place, disparities, or variations, exist between these jurisdictions. In the second place, a State may – in the exercise of its sovereignty – treat situations that arise fully within their own jurisdiction differently from those that are partly within their jurisdiction and partly in the jurisdiction of another State. These consequences are discussed below.

1. Disparities. A consequence of the co-existence of discrete national tax systems is that disparities, or variations, exist between these jurisdictions. For example, a State may choose to impose a relatively high tax rate within its jurisdiction. The existence of these disparities has inevitable distorting effects on investment, employment and, for companies

[314] Van Raad (loose-leaf),1.2.2.B.
[315] Van Raad (loose-leaf),1.2.2.C.
[316] Van Raad (loose-leaf),1.2.2.D.

and self-employed persons, establishment decisions. A taxpayer who wishes to transfer his activities to a State other than that in which he previously resided will not necessarily be neutral as regards taxation. Given the disparities in the tax legislation, such a transfer may be to the taxpayer's advantage in terms of taxation or not, according to circumstance.

2. Items of income outside the tax jurisdiction. If, for example, a French company opens a branch in Luxembourg, the losses attributable to the French head office will normally not be taken into account for determining the profits of the branch for Luxembourg corporation tax purposes, whereas the losses of a domestic head office would be deductible. The reason for this different treatment is that the French company – neither a national nor a resident of Luxembourg – is only subject to limited taxation in Luxembourg.

3. A taxable subject or object leaves the tax jurisdiction. If a taxpayer owning assets with an unrealized gain or these assets themselves leave a State's jurisdiction, that State will normally impose an exit tax on that unrealized gain. The reason for this is that the State concerned loses its jurisdiction to tax, whereas it considers it reasonable to tax the unrealized gains which have accrued on its territory. In the Netherlands, for example, if an individual who has a substantial interest (more than 5%) in the shares of a company emigrates to another country, the Netherlands will in principle tax the unrealized gain present in the shares.[317] Also, a State may consider it as an abuse of its tax legislation that a taxpayer or asset leaves its jurisdiction in order to benefit, for example, from the tax regime of a low taxing country. An example of specific anti-abuse legislation aimed at combating such abusive transfers can be found in CFC-legislation. This legislation leads to the taxation of the profits of a subsidiary established in a low taxing country at the level of its parent company. Rules which limit the deduction of interest paid to a recipient which is a resident of another country have a similar aim. The reason for these types of anti-abuse legislation is that the State applying that legislation has an absolute lack of jurisdiction over adjusting the tax rate of the tax base applied in the other country.

Limitation of direct tax jurisdictions by tax treaties or internal law

States are competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation either unilaterally or by means of international agreements. They are, in other words, free not to fully exercise the jurisdiction entrusted to them by customary international law. Two phenomena should be distinguished. In the first place, States may not fully exercise the tax jurisdiction to which they are entitled on the basis of the person of the taxpayer (e.g. a national). In the second place, States may exclude certain categories of income from the tax base. These categories will now be discussed.

1. Exclusion of a taxable subject from the tax jurisdiction. Many States have unilaterally decided not to exercise tax jurisdiction on the basis of the nationality of natural persons, whereas they do tax residents on the basis of their world-wide income. Other exclusions of taxpayers from the tax jurisdiction are also possible.

2. Exclusion of a taxable (negative) object from the tax jurisdiction. A German company with income from industrial or commercial activities is precluded, when calculating its profits, from deducting losses from a permanent establishment in another Member State on the ground that, according to the applicable double taxation convention,

[317] Article 4.16(1)(h) Wet IB 2001.

the corresponding income from such a permanent establishment is not subject to taxation in Germany. Similar measures may be taken unilaterally. In this category of 'dislocations' or 'tax base fragmentations', to which Wattel has drawn attention, a disadvantageous tax effect is caused by the fact that the tax base (the income) is created in two tax jurisdictions and the resulting need to divide that base between the two jurisdictions (fragmentation) and for double tax relief mechanisms.[318] This issue has also been dealt with in the paragraph on customary international law, with one important difference: the exclusion of a (negative) item of income from the tax base unilaterally or bilaterally is a *choice*, whereas the exclusion of an item of income on the basis of customary international law is an obligation, if other States refuse to conclude an international agreement which deviates from customary international law.

3. Allocation of tax jurisdiction in tax treaties and disparities. Tax treaties divide the tax jurisdiction between the contracting States. Obviously, the choices laid down in the tax treaty directly affect taxpayers. An allocation of tax jurisdiction to the State with the highest level of taxation leads to a tax treatment which is harsher than it would have been if the tax jurisdiction had been allocated to the State with the lowest level of taxation. Consequently, the worse treatment is caused by two circumstances: i. the choice to allocate the taxing power to State A and ii. the fact that State A has a higher effective tax rate than State B. The second cause is the direct result of the fact that direct taxes are not harmonized: a different treatment caused by disparities. The first cause reflects the freedom of States to choose the connecting factors for allocating jurisdiction in tax treaties.

4. A taxable subject or object leaves the tax jurisdiction as defined by a tax treaty or unilaterally. The choice made in a tax treaty or unilaterally not to exercise a State's full tax jurisdiction under customary international law normally leads to more exit taxes: if a taxpayer owning assets with an unrealized gain or leaves a State's jurisdiction thus defined, that State will normally impose an exit tax on that unrealized gain. The same applies to assets leaving that tax jurisdiction. The reason for this is that the State concerned loses its jurisdiction to tax, thus it considers it reasonable to tax the unrealized gains which have accrued on its territory.

5.3 Equality of nation States, the reserved domain and the principle of non-intervention

The fact that a State's tax jurisdiction is limited by customary international law, bilateral tax treaties and unilateral delimitations implies an obligation for that State to respect the direct tax sovereignty of other States. Sovereignty implies a right against interference or intervention from any foreign (or international) power.[319] It is important to discuss this aspect of sovereignty, because it may serve as a limit to free movement under the theoretical assessment model (see section 7.4.4). The content of the concept of sovereign equality of States is developed in the Declaration on Friendly Relations:

[318] Terra & Wattel 2008, p 48. See section 2.2.5 for a discussion.
[319] Jackson 2006, p. 58; Vanhamme 2001, p. 48-50.

> "All States enjoy sovereign equality. They have equal rights and duties and are equal members of the international community, notwithstanding differences of an economic, social, political or other nature. In particular, sovereign equality includes the following elements:
> (a) States are juridically equal;
> (b) Each State enjoys the rights inherent in full sovereignty;
> (c) Each State has the duty to respect the personality of other States;
> (d) The territorial integrity and political independence of the State are inviolable;
> (e) Each State has the right freely to choose and develop its political, social, economic and cultural systems".[320]

Jeffery has noted that it is implicit in the principle of the equality of nation States that sovereign rights are not exercised in a vacuum but in the context of the existence of other States with commensurate jurisdiction. Consequently, what one State sees as an exercise of its sovereign jurisdiction may be seen by the other as an infringement of its own sovereign jurisdiction. "How the balance is to be established between competing sovereign interests, especially in the case of an extra-territorial assertion of jurisdiction, lies at the heart of the questions relating to legislative jurisdiction."[321] In this context, the German Constitutional Court has handed down an interesting judgment in 1983. It held that the imposition of taxes upon a foreigner living abroad requires sufficiently appropriate points of contact for taxation by the taxing State in order to prevent interference with the foreign State's claims to sovereignty ("eine völkerrechtswidrige Einmischung in den Hoheitsbereich eines fremden Staates").[322]

According to Jeffery, a three-step approach to the meaning of the reserved domain of exclusive domestic jurisdiction should be followed. Under this approach the operation of international law can be divided into three different areas. Firstly, there is that area which international law governs by means of positive rules. According to Jeffery, the prime tax illustration of this are the provisions of the OECD Model allocating a State's jurisdiction to tax. Secondly, comes the true reserved domain - that area which international law does not want to regulate because it is best suited to regulation by States operating independently of its prescriptions. Jeffery states that this would include such matters as the determination of which persons and transactions will be taxable and the types and rates of taxes that will be imposed. Thirdly, there is that area which it has not succeeded in, or got around

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320 General Assembly Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in Accordance with the Charter of the United Nations, 24 Oct. 1970, G.A. Res. 2625 (XXV).

321 Jeffery 1999, p. 21.

322 BVerfGE 63, 343 (Beschluß des Zweiten Senats vom 22. März 1983): "Für die Auferlegung von Abgaben gegen einen im Ausland lebenden Ausländer, die an einen Sachverhalt anknüpft, der ganz oder teilweise im Ausland verwirklicht worden ist, bedarf es, soll er nicht eine völkerrechtswidrige Einmischung in den Hoheitsbereich eines fremden Staates sein, hinreichender sachgerechter Anknüpfungsmomente für die Abgabenerhebung in dem Staat, der die Abgaben erhebt (compare F. A. Mann, The doctrine of jurisdiction in international law, in: Recueil des Cours, 111 [1964 - I], S. 9 ff., 44 ff., 109 ff.). Diese Anknüpfungsmomente und ihre Sachnähe müssen von Völkerrechts wegen einem Mindestmaß an Einsichtigkeit genügen."

to, regulating which by its nature is susceptible to regulation by international law. Jeffery suggests that international direct tax distortions would come under this category.[323]

Thus, the rules on direct tax jurisdiction as they are laid down in customary international law have two functions which are essentially two sides of the same coin. Firstly, these rules *permit* a State to determine the organization and aims of its tax system within its domestic jurisdiction. Secondly, they *prohibit* that a State interferes with the domestic jurisdiction of other States.

5.4 Freedom to determine the organization and aims of the tax system within the domestic jurisdiction

5.4.1 Introduction

It has been argued in the previous section that States have the exclusive right to regulate within their domestic jurisdiction. This means that national States are competent to determine the objectives of their respective tax systems.[324] Obviously, the first goal would be to collect taxes for the financing of the State in a manner which is conceived as equitable and fair, but there will also be other – external – objectives. Internal objectives include the way in which the tax is levied: the definition of the taxable persons, the tax base and the tax rate. External objectives include fiscal incentives which are granted to foster objectives outside the scope of the tax system itself such as the promotion of the environment. Secondly, States are competent to allocate between themselves the jurisdiction to tax through the conclusion of tax treaties or unilaterally. They are also free not to remedy international juridical double taxation.

The distinction between 'internal' and 'external' objectives of the tax system has been – and still is – subject to wide debate among economists and tax scholars in the discussions on the desirability of so-called tax expenditures.[325] In 1973, Surrey argued that the income tax system really consists of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which Governmental financial assistance programs are carried out through special tax provisions rather than through direct Government expenditures.[326] Together with McDaniel, Surrey developed this distinction between 'taxing' and 'spending' provisions further. They argued that an income tax is composed of two distinct elements. "The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the definition of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions compose the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income

[323] Jeffery 1999, p. 38-39.

[324] Compare in an EU context Isenbaert 2010, p 223, who confirms the function-sovereignty of EU Member States in the policy area of direct taxation.

[325] See for a comprehensive summary of the debate Infanti 2005.

[326] Surrey 1973, p. 6.

tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal structure and are designed to favour a particular industry, activity or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favoured activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance."[327]

The difference between 'structural' provisions of an income tax and exceptions thereto is also relevant for identifying State aid under Article 107 TFEU. As the Commission states in its Notice on the application of the State aid rules to measures relating to direct business taxation:

> "A distinction must be made between, on the one hand, the external objectives assigned to a particular tax scheme (in particular, social or regional objectives) and, on the other, the objectives which are inherent in the tax system itself. The whole purpose of the tax system is to collect revenue to finance State expenditure. Each firm is supposed to pay tax once only. It is therefore inherent in the logic of the tax system that taxes paid in the State in which the firm is resident for tax purposes should be taken into account. Certain exceptions to the tax rules are, however, difficult to justify by the logic of a tax system. This is, for example, the case if non-resident companies are treated more favourably than resident ones or if tax benefits are granted to head offices or to firms providing certain services (for example, financial services) within a group."[328]

This distinction between internal and external objectives of a tax system is necessary to assess whether the tax system in question grants an advantage to certain taxpayers, which may – for example – amount to illegal State aid.[329] External objectives of a tax system can however be achieved not only through tax preferences, but also through tax penalties: negative tax expenditures.[330] If such a disadvantage is only directed at certain taxpayers, this might amount to a *prima facie* prohibited obstacle in the European Union's internal market.

The identification of advantages or disadvantages boils down to the benchmark tax system: what is the 'normal' rule and what is the exception? Indeed, as stated in the 1996 OECD Report on tax expenditures, defining a tax expenditure is a classification exercise: dividing the provisions of the tax system into a benchmark or norm and a series of deviations from that norm.[331] Scholars have not been able to reach consensus on the

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[327] Surrey & McDaniel 1985, p 3.

[328] Commission Notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384 , 10/12/1998 p. 3-9, § 26.

[329] Commission Notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384 , 10/12/1998 p. 3-9, § 26. See recently Joined Cases T-227/01 to T-229/01, T-265/01, T-266/01 and T-270/01 *Territorio Histórico de Álava*, § 182.

[330] This term is used, *inter alia*, by Shaviro 2003, p 39.

[331] Tax Expenditures, Recent Experiences, OECD 1996, p 9.

definition.[332] Goudswaard and Vording have observed that there are two ways of looking at it.[333] Firstly, one can take the 'normative income tax' as the benchmark. This includes the formulation of an ideal notion of income, regardless of the notion of income which is in fact the basis for the income tax act in question. Secondly, one can take the statutory notion of income as the point of reference. In that case, one should ascertain whether a certain deduction or exemption fits within the general principles on which the income tax is based. If not, the deduction or exemption is a tax expenditure.

In my view, the categorization of a measure either in the category 'structural provisions' or 'tax preferences or penalties' should be inferred from the aim of the measure in question, having regard to the fact that States are themselves competent to determine whether they want to impose an income tax in the first place and, secondly, to define the concept of income which they want to tax. States are also at liberty to grant advantages or disadvantages to certain (groups of) taxpayers or activities. Normally, as Infanti states, the arguments made by the legislator in support of a provision will identify it either as structural in nature or as a tax preference or penalty.[334] Thus, the policy choices made by the tax legislator of the State concerned will determine the classification of a certain tax measure.

Section 5.4.2 will describe selected internal and external aims which may be adopted by national tax legislators. This overview has two goals. In the first place, it is an illustration of national tax sovereignty – a concept which has to be reconciled with the free movement provisions of the TFEU (the specific aims referred to below are inspired by the ECJ's case law). In the second place, the categorization of tax measures as structural or as exceptional in the light of the objective of the overall system may prove to be useful for the EU law analysis of a certain measure: an analysis under the free movement provisions or under the State aid rules.

5.4.2 Measures of general income tax policy

The primary and classical function of taxation is to collect the money necessary to pay for the burden of social charges. This burden should be spread in such a way that the members of the society regard it as just and acceptable.[335] Therefore, tax systems are designed in such a way that the tax is levied according to what is considered reasonable and fair by a society at a certain point in time. Stiglitz has formulated five basis principles by which a tax system should abide.[336] In the first place, a tax system should be efficient. It should not be distortionary and if possible it should be used to enhance economic efficiency. In the second place, it should meet requirements of administrative simplicity: low costs of administration and compliance. In the third place, the tax system should allow easy adaptation to changed circumstances (flexibility). In the fourth place, the tax system should be transparent (political responsibility). In the fifth place, the tax system should be, and

[332] See Kraan 2004 and Hemels 2005, chapter 2.
[333] Goudswaard & Vording 1990, p 232.
[334] Infanti 2005, p 724.
[335] Stevens 2004, § 1.2.
[336] Stiglitz 1999, p 458.

should be seen to be, fair, treating those in similar circumstances similarly, and imposing higher taxes on those who can better bear the burden of taxation. Measures which are aimed at achieving these goals may be seen as a part of the 'structural' provisions of an income tax. Some of these are discussed below.

Taxable persons, taxable basis and tax rate
The main function of income taxation remains the collection of public funds. The backbone of an income tax system is therefore formed by the definition of taxable persons, taxable income and the tax rate. These are the core elements of each income tax system, just as – for example – depreciation rules and rules on loss carry-overs. States are free to exempt persons or entities from income tax, to define the concept of income and to determine the tax rate including, for example, a withholding tax rate to be withheld at source (e.g. on dividend, interest and royalty payments). More secondary goals are laid down in general measures of tax policy, to which we shall now turn.

Personal ability to pay tax
States may think of income as evidencing ability to pay, which has been selected as the proper criterion for distributing the costs of government.[337] Most States consider it fair to take account of the personal and family circumstances of the individual tax payer. Thus, income taxes tend to have a progressive tax rate – a certain amount of income should not be taxed at a high tax rate because every person needs a certain amount of money for the primary necessities of life – and specific deductions aimed at taking account of the specific situation of the individual taxpayer (e.g. handicapped, divorced, married etc.). These advantages are not enacted to induce certain activities or behaviour in response to the monetary benefit available, but are generally intended to relieve hardships. These hardships can be either personal (e.g. extraordinary medical expenses or blindness) or administrative (e.g. complex tax computations) in nature.[338]

The avoidance of international juridical double taxation
The application of the rules of customary international law with regard to fiscal jurisdiction may lead to international juridical double taxation. Many States provide for a relief for the avoidance of international juridical double taxation, either unilaterally or though tax treaties. Reference is made here to section 5.2 where these rules have been discussed. The choice to avoid international juridical double taxation and the way in which this should take place is normally reflected in an income tax system. One could say that these rules are in some ways different from other measures of general income tax policy, because they are not only aimed at achieving taxpayer equity, but also inter-nation equity. I will come back to this in section 5.5.

The avoidance of economic double taxation
Many States consider it unreasonable that profits of a company are taxed more than one time with an income tax. They have developed systems which are aimed at avoiding

[337] Shaviro 2003, p 34.
[338] Infanti 2005, p 727, with further references.

economic double taxation either at the level of the shareholder receiving a dividend or at the level of the distributing company. Various relief systems or integration systems coexist. The 2003 General IFA Report on "Trends in company shareholder taxation: single or double taxation?" provides a good overview of possible systems.[339] The systems illustrated in the General Report are a full imputation/tax credit system, a classical system, a dividend exemption system (that is, where the dividend is exempt from tax in the hands of the shareholder), a half inclusion system, a flat rate dividend tax system (generally done by final withholding tax), and a dual income tax system.[340] In addition, a split rate system can be identified. Often combinations of two or more of these systems can be seen.

A split rate system taxes distributed profits at the level of the distributing company at a lower rate than retained profits. The purpose of this lower tax rate is to serve as a mitigation of the economic double taxation arising in the hands of the shareholder receiving the dividend.

An imputation system grants a tax credit to the shareholder receiving the dividend for the corporation tax paid by the distributing company. The result is that the company's income is effectively taxed at the top individual tax rate.

A classical system does not grant relief for the avoidance of economic double taxation. In those systems, arguments of simplicity are considered to weigh heavier than the goal of taxing the same income only once.

A dividend exemption system exempts the distributed dividend in the hands of the shareholder. As a consequence, the tax burden on the company income equals the corporation tax paid by it.

A half inclusion system taxes one half of the dividend paid out in the hands of the shareholder. In this way, economic double taxation is not avoided but mitigated.

A flat rate system usually applies a final flat rate withholding tax to the dividend. This rate is lower than the "normal" rate of the system, as a result of which economic double taxation is mitigated.

A dual income tax system applies different tax rates to different types of income. Normally income from capital is taxed at a lower income tax rate than labour income.

Group taxation

From an economic point of view, a corporate group forms an economic unit. Many States find it desirable to adapt their tax systems to this.[341] They may treat a corporate group as if it were a single corporation through a full tax consolidation of the different entities belonging to the group (e.g. the Netherlands). It is also possible to adopt another form of consolidation model which does not lead to a full consolidation. In such a system, corporate income is computed separately at the level of each member (intra-group transactions are visible), and combined at the group level after some adjustments. The

339 Vann 2003.

340 Vann 2003, p 28.

341 See for an overview IFA Cahiers 2004, *Group taxation*, No. 89b. Some EU Member States do not find it necessary to have any form of group taxation: Belgium, the Czech Republic, Estonia, Greece, Hungary, Lithuania and the Slovak Republic.

parent company is liable to pay tax on behalf of the entire group.[342] A third manifestation of a form of consolidation can be found in the concept of *Organschaft* (known in Germany and Austria). The German *Organschaft* envisages the attribution (*Zurechnung*) of profits and losses from a subsidiary (*Organgesellschaft*) to a parent (*Organträger*) for economic and tax purposes. Companies within an *Organschaft* remain separate tax subjects and the taxation of intra-group transactions is not eliminated.[343] A fourth form of group taxation can be seen in the system of group relief.[344] It enables the transfer of losses from one group company to another. A fifth form of group taxation is the system of group contribution (Sweden, Norway and Finland). It allows the transfer of profits from one group company to another.

Equal treatment of direct and indirect investment

A last example of a measure of general income tax policy is provided by the regimes on fiscal investment funds which many States have in place. The Dutch regime for portfolio investment companies, for example, is aimed at an equal treatment of direct portfolio investments vis-à-vis indirect investments through the intervention of a portfolio investment company.[345] To that end, the portfolio investment company is taxed in such a way as if the revenues gained by the portfolio investment company had been gained by the funds' shareholders directly: the fund is subject to a corporation tax rate of 0% if it meets the statutory requirements, notably the obligation to distribute its profits to the shareholders within eight months after the book year concerned. Subsequently, the shareholders are taxed on the dividend.

Procedural rules and collection of the tax

States are at liberty to set out the rules according to which income taxes are levied. They are free, for example, to tax through the imposition of a tax assessment or through withholding taxes. Also, States set rules under which mistakes made by the tax authorities may be repaired. Statutory time limits for claiming advantages by taxpayers or for issuing a tax assessment by the authorities are also to be determined. The way in which a taxpayer should prove that he is entitled to a certain tax advantage will also be determined by the State.

Measures to combat tax evasion and tax avoidance

Taxes are high in a modern social welfare State. Citizens and companies are tempted either to commit fraud or to make improper use of the tax law in order to avoid taxation. It is, therefore, essential for each tax system that it is capable of combating tax evasion and tax avoidance. Were it not capable of doing that, the primary function of collecting taxes for the benefit of the common interest would not be achieved. Also, it would lead to an unfair

342 See Masdui 2004, p 30. The following EU Member States have such a system: Austria, Denmark, France, Germany, Italy, Luxembourg, Poland, Portugal, Slovenia and Spain.

343 Douma & Naumburg 2006. For a further analysis of the compatability of this concept with EU law see Lüdicke, Brink & Braunagel 2010, p 310-311.

344 In force in the United Kingdom, Cyprus, Ireland, Latvia and Malta.

345 See for a summary of this system Case C-194/06 Orange European Smallcap Fund NV, § 3-11.

allocation of the total tax burden to the 'honest' taxpayers who do not engage in improper activities. Tax evasion is usually suppressed by a system of penal sanctions, since it may involve criminal offences like forging documents, the concealment of taxable income or the deliberate provision of false information. Operations by taxpayers which are not aimed at outright fraud but rather at the circumvention of the tax law or at obtaining unintended advantages are usually dealt with by specific anti-avoidance provisions or by general anti-avoidance rules. As the European Commission has explained, "[t]he notion of "anti-abuse rules" covers a broad range of rules, measures and practices. Some Member States apply a general concept of abuse based on legislation or developed in case law. Others apply more specific anti-abuse provisions, such as Controlled Foreign Corporation (CFC) and thin capitalization rules which aim to protect the domestic tax base from particular types of erosion. Other types of specific anti-abuse provisions include switch-over from exemption to credit method in certain cross-border situations (where foreign source income has been subject to a low or preferential tax rate) and provisions explicitly targeted at passive investment in other countries. Many Member States apply a combination of general and specific anti-abuse rules."[346]

A Dutch example of a general anti-avoidance rule can be found in the unwritten concept of *fraus legis*. It is settled case law of the *Hoge Raad* that two criteria have to be met simultaneously before *fraus legis* can be applied: a subjective criterion (that the avoidance of tax is the only, or paramount, motive for the transactions) and an objective criterion (a conflict with the intention and purport of the law).[347] The legal transactions entered into by the taxpayer to obtain a fiscal advantage can either be ignored (elimination) or replaced by other transactions (substitution), depending on which option gives the best expression to the intention and purport of the law. Application of the doctrine of *fraus legis* in tax matters does not change the legal qualification of the transactions for any other purposes than that of taxation.

Examples of specific anti-abuse measures include CFC rules and thin capitalization rules. As summarized by the Commission, the main purpose of CFC rules is to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in low tax countries. The scope of CFC rules is generally defined by reference to criteria regarding control, effective level of taxation, activity and type of income of the CFC. They typically provide that profits of a CFC may be attributed to its domestic shareholders (usually a parent company) and subjected to current (immediate) taxation in the hands of the latter (whereas normally the parent company would be taxed on the profits of its foreign subsidiary only at the time of repatriation).[348] As regards thin capitalization rules, the Commission has noted that there are many different approaches to the design of thin capitalization rules but the background to these rules is similar. "Debt and equity financing attract different tax consequences. Financing a company by means of equity will normally result in a distribution of profits to the shareholder in the form of dividends, but only after taxation of such profits at the level of the subsidiary. Debt financing will

346 Communication on the application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785 final, p 2.

347 HR 20 March 1985, BNB 1985/171.

348 Memo of 10 December 2007, No. MEMO/07/558.

result in a payment of interest to the creditors (who can also be the shareholders), but such payments generally reduce the taxable profits of the subsidiary." [349] To counter this problem, many Member States have introduced specific thin capitalization provisions dealing with structured debt financing schemes. Typically these limit the deductibility of interest paid on loans taken with (or otherwise arranged by) shareholders to the extent that the subsidiary is considered to be excessively 'thinly' capitalized.

Specific anti-avoidance rules are not necessarily limited to situations with a cross-border character. An example of a Dutch anti-abuse provision which applies to the same extent to domestic and cross-border situations concerns the carry-over of losses upon changes in ownership of the company concerned. Losses incurred by a company that wholly discontinues its business may generally only be carried forward if at least 70% of its shares continue to be held by the same individual shareholders. If a company reduces its business by more than 70% and less than 70% of its shares continue to be held by the same shareholder(s), losses that have not been offset may only be set off against future profits arising from the original business activities.[350]

5.4.3 Measures of general economic policy

Whereas general measures of tax policy reflect the wider interest of collecting taxes for financing the social welfare State, general measures of economic policy aim at specifically promoting a certain goal. In other words, measures of tax policy aim at collecting money in a manner which is considered fair, whereas measures of economic policy aim at spending money or at discouraging certain behaviour by imposing a special burden on a product or a producer. Thus, States try to influence the structure of the domestic production and consumption pattern. This is called the allocational function of tax law.[351] Special burdens to discourage behaviour are normally imposed through excise duties (e.g. on tobacco), customs duties or specific consumer taxes. Special advantages to encourage certain behaviour may be granted through (corporate) income taxes. Examples include a reduction of the tax burden related to certain production costs such as research and development (R&D), the environment, training and employment.[352] Economic literature refers to these advantages with the term 'tax expenditures'. As I have argued in 5.4.1, the categorization of a measure in either the category 'structural provisions' or 'tax preferences or penalties' should be inferred from the aim of the measure in question. The arguments made by the legislator in support of a provision will identify it either as structural in nature or as a tax preference or penalty.

Tax expenditures

Tax preferences may be expressly enacted with the idea of inducing action in the national

[349] Communication on the application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785 final, p 7.

[350] Offermans 2008; see Article 20a of the Dutch CITA.

[351] Stevens 2004, § 1.3.b.

[352] Examples derived from the Commission Notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384 , 10/12/1998, p. 3-9, § 13.

interest, while others may have unclear origins but are now defended on incentive grounds.[353] The deductions for accelerated depreciation and charitable contributions are examples of income tax provisions in the former category, and the deductions for home mortgage interest are examples of income tax provisions in the latter category.[354]

According to a 1996 OECD Report, tax expenditures may take a number of forms.[355] In the first place, income may be excluded from the tax base (exemptions). In the second place, allowances may be granted, e.g. amounts may be deducted from gross income to arrive at taxable income. In the third place, a system of tax credits may be introduced (amounts deducted from tax liability). If these are not allowed to exceed the tax liability they are termed 'wasteable'; if an excess of the credit over the liability is returned to the taxpayer the credit is called non-wasteable. In the fourth place, States may opt for a rate relief. In such a case a reduced rate of tax is applied to a class of taxpayers or activities. In the fifth place tax deferrals may be enacted. This is a relief which takes the form of a delay in paying tax.

Non-fiscal objectives which national governments wish to achieve through these measures often concern the promotion of environment-friendly economic activity, research and development, training, employment, stimulating starting businesses, housing, increasing economic activity in certain regions and many other social-economic goals.

Tax penalties

Tax penalties are the converse of tax preferences. Rather than departing from the normative income tax in order to provide government assistance to a taxpayer by lowering her tax burden, a tax penalty departs from the normative income tax by requiring a greater tax payment than would occur under the normative net income base, thereby increasing the taxpayer's tax burden.[356] Geelhoed has contrasted tax preferences and tax penalties as follows:

> "between and within national economies imbalances may (…) occur in parts of sectors: these are referred to as *specific* distortions. They stem from specific interventions by the authorities as a result of the imposition of exceptional charges on certain kinds of production or on certain undertakings or as a result of the grant of exceptional benefits. In regard to exceptional burdens those are frequently interventions by the authorities which are known in modern management terms as burdens imposed with a view to regulating conduct. They occur more and more frequently in environmental and planning policy. In a certain sense they are the mirror image of exceptional benefits or aid which seek to influence the conduct of market participants by means of incentives rather than disincentives."[357]

[353] Infanti 2005, p 725, with further references.
[354] Infanti 2005, p 725-726.
[355] Tax Expenditures, Recent Experiences, OECD 1996, p 9.
[356] Infanti 2005, footnote 60, with further references.
[357] Opinion AG Geelhoed in Case 308/01 GIL Insurance, § 64.

An example of tax penalties in income taxes can be found in various 'public policy' provisions that deny deductions for certain business expenses involving lobbying, bribes, or fines.[358]

5.5 Taxpayer equity and inter-nation equity

The preceding sections have discussed three main consequences of national tax sovereignty. In the first place, States are in principle free to adopt tax legislation within their domestic tax jurisdiction, as determined by customary international law, and to pursue any kind of policy objectives they consider necessary. These objectives may involve measures of general tax policy or measures of general economic policy. Measures of general tax policy reflecting the "structural" provisions in the tax system generally seek to achieve taxpayer or inter-individual equity. The meaning of the concept of income in a certain national income tax reflects a decision concerning equity. Horizontal equity means that taxpayers in similar circumstances should pay a similar amount of tax. Vertical equity means that taxpayers who earn more income should pay more tax.[359] Measures of general economic policy include provisions in a tax system which are not regarded as structural but as "preferential" or "punishing". These measures do not reflect decisions about equity as such. They are, however, implemented in accordance with ideas of equity. In other words, taxpayers who find themselves in similar situations in the light of the aim and purpose of the economic policy goals pursued by the measure should be taxed in a similar way. It is important to note that the concept of taxpayer equity can only be applied by a State to taxpayers in its own jurisdiction. In an example given by Jeffery, it is not an achievable goal to expect a taxpayer earning € 20,000 in country A in particular circumstances to pay the same amount of tax as a taxpayer in country B in similar circumstances. These taxpayers are in inherently unequal positions due to the variations which exist in different countries.[360]

In the second and third place, customary international law limits the scope within which States can exercise direct tax jurisdiction. Within these limits States are free to allocate among themselves, either unilaterally or bilaterally, the power to tax certain items of income. Thus, they are free to determine which State should not tax the income (negatively) and which State should be entitled to tax the income (positively). The allocation of direct tax jurisdiction through customary international law, treaties or unilateral rules concerns an entirely different level of equity, namely 'inter-nation equity.'[361] This requires that the worldwide tax base be fairly shared between States.[362]

The competence to ensure both taxpayer equity and inter-nation equity are fundamental aspects of direct tax sovereignty. This includes the definition of what is equitable as well as the competence to ensure these equitable principles, either unilaterally or through international agreements. It is important to stress this, because both aspects of equity are

358 Infanti 2005, footnote 60, with further references.
359 Jeffery 1999, p 10.
360 Jeffery 1999, p 11.
361 The term has been coined by Musgrave & Musgrave 1972.
362 Jeffery 1999, p 11.

capable as serving as a limit to the principle of EU free movement under the theoretical optimization model which will be outlined in chapter 7.

5.6 Conclusion

This chapter has examined the notion of national direct tax sovereignty. It has been argued that sovereignty should be regarded as a principle – i.e. an optimization requirement – in Alexy's sense rather than as a rule of international law: it is a *prima facie* general freedom of action by States which should be realized to the greatest extent relative to what is factually and legally possible. Tax sovereignty is, in other words, in no way absolute. Its extent should be determined in the context of a theoretical optimization model which will be outlined in chapter 7.

The purpose of the present chapter has been to illustrate the *prima facie* position of the principle of tax sovereignty and the consequences thereof. States are free to adopt tax legislation within their domestic tax jurisdiction, as determined by customary international law, and to pursue any kind of policy objectives they consider necessary. Tax systems generally consist of 'structural' provisions and 'tax preferences or tax penalties'. Thus, tax systems have both internal and external objectives. It is important to emphasize these two essentially different objectives, because the compatibility of a certain tax measure with competing principles should be assessed in the light of the aims pursued by the measure in question. Another consequence of national tax sovereignty is that the domestic jurisdiction of States is necessarily limited in scope. This makes it likely that disparities or variations exist between the tax systems enacted in the various jurisdictions. At the same time, domestic tax jurisdictions tend to overlap, as a result of which international juridical double taxation arises. In that context, States are competent to define, by tax treaty or unilaterally, the criteria for allocating their powers of taxation. The choices made in this regard may give rise to different treatment either because the State to which the taxing power has been allocated has a higher level of taxation or because certain negative items of income have been allocated to another jurisdiction than certain positive items of the same taxpayer. In addition to these types of different treatment, the fact that tax jurisdictions are necessarily limited in scope restrains the extent to which States can effect their internal and external policy objectives in their tax legislation.

The following chapter will discuss the *prima facie* requirements of the free movement provisions of the TFEU.

6. The principle of free movement

6.1 Free movement as a principle

Articles 30, 34-35 and 110-112 TFEU (free movement of goods), Article 45 TFEU (freedom of movement for workers), 49 TFEU (freedom of establishment), 56 TFEU (freedom to provide services) and Article 63 TFEU (free movement of capital and payments) contain a *prima facie* prohibition of obstacles to the free movement of goods, persons, services and capital. In addition, Article 21 TFEU guarantees the right of citizens to travel and reside freely in the EU. Thus, the principle of free movement *prima facie* protects a general freedom of cross-border (economic) action of persons. The question arises as to whether these provisions should be regarded as either rules or principles in Alexy's sense (see section 4.2). Alexy's theory distinguishes rules from principles by examining what happens in the case of a conflict between those norms. If two rules conflict with each other, the solution will be to disapply one of the rules. If two principles collide, however, the solution is not found by disapplying one of the principles, but by realizing both of them within what is factually and legally possible. If free movement were a rule rather than a principle, it would either trump national tax sovereignty in all circumstances, or it would need to be disapplied (a rule applies unless it is not valid; see section 4.2). Obviously, this is not the case. The confrontation between tax sovereignty and free movement cannot lead to the disapplication of either of the two, but their extent should be determined through an optimization process. The idea that the extent of free movement can only be determined in confrontation with competing rules and principles is important because, if it were otherwise and its extent were unlimited, it would *de facto* deny that there is such a thing as sovereignty of Member States. Borgmann-Prebil has therefore rightly stated that free movement is "best understood as a general, wide-ranging, *prima facie* right that can be limited by virtue of countervailing 'objective considerations of public interest' whether specific manifestations of these are enshrined in specific provisions of (secondary) Community law or not." Both the fundamental right as well as those countervailing considerations are best conceptualized as optimization precepts in Alexy's sense.[363] I fully agree with this observation.

The *prima facie* position of the principle of direct tax sovereignty has been discussed in chapter 5. The *prima facie* requirements of free movement will now be examined. This examination will be carried out without reference to the case law of the ECJ, because the widest scope of the free movement principle should be adopted according to Alexy's theory on the scope of principles (section 4.3). If the ECJ's case law were taken into account here, the theoretical optimization model which will be presented in the next chapter would become 'polluted', as a result of which it would no longer be possible to test the case law against that model.

[363] Borgmann-Prebil 2008, p 349. See also Conway 2010, p 69.

6.2 Aims of the internal market

According to Article 3(3) TEU, the Union shall establish an internal market.[364] Article 26(2) TFEU states that the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties. The TEU and the TFEU do not contain, however, a general definition of the notion of an internal market. There are a number of possible ways of looking at it.

The first approach is an economic one. As Barnard explains, economists have developed a set of labels to describe different levels of intensity of market integration. The term 'common market' is perceived as involving a free trade area, a common external policy in respect of non-Member States (e.g. a single customs tariff) and free movement of persons, services and capital.[365] A free trade area and a customs union focus on the free movement of *products*. A common market is broader, because it allows for free movement of *production factors* (workers and capital) as well as products. In a common market, both goods and factors of production can move.[366] A common market would thus imply the removal of barriers to trade.

The second approach pays more attention to the system of the TFEU which Articles 28-118 TFEU lay down. This approach emphasizes that the notion of an internal market comprises more than free movement alone. The reference to the term 'internal market' in Articles 101 and 102 TFEU (competition rules applying to undertakings), Articles 107 and 108 TFEU (a *prima facie* prohibition of State aid) and Articles 114-118 TFEU (approximation of laws) demonstrates that these areas are also relevant for the realization of an internal market. Barents and Brinkhorst argue that the internal market may therefore be described as a situation in which the obligations Articles 28-118 TFEU impose on the Member States, the institutions of the Union and individuals are fully observed and realized.[367]

The third approach clarifies the term 'internal market' by drawing a parallel with the market which existed within one single Member State. Barents and Brinkhorst point out that national markets are normally characterized by an unqualified free movement of goods, services, persons and capital, the existence of competition rules and a common legal system.[368]

The fourth approach places a high emphasis on fundamental rights and freedoms. This approach interprets the internal market in terms of economic freedom of the individual. Barents and Brinkhorst contend that the rules on free movement and competition essentially mean that natural and legal persons can enjoy their rights to property anywhere in the Union and that there are freedoms of contract and profession.[369] Every European

[364] According to Article 2 EC the basis of the European Community was formed by the establishment of a 'common' or 'internal' market (these terms are, just as the term 'single' market, largely synonymous; Barnard 2010, p 12).

[365] Barnard 2010, p 9. See also Craig & De Búrca 2008, p 605.

[366] Barnard 2010, p 9-10.

[367] Barents & Brinkhorst 2006, p 298.

[368] Barents & Brinkhorst 2006, p 298.

[369] Barents & Brinkhorst 2006, p 298-299.

citizen and legal person can invest, produce, buy and offer services and products, borrow and lend capital and work anywhere in the Union, depending on the place where the economic conditions are the most favourable. Barents and Brinkhorst gather from this that the rules on free movement and competition should be seen as *fundamental rights*, the purpose of which is to protect economic liberties from being restricted by Member States and undertakings.[370] This view is underlined by Article 3 TEU which states that the Union shall establish an internal market and shall offer its citizens an area of freedom, security and justice without internal frontiers, in which the free movement of persons is ensured. According to Barents:

> "The emerging concept of "European area" embodied in this formula reflects that the foundation of the European Union is constituted by an area in which the individual, in particular the European citizen, is free to exercise his civil, economic, social and cultural fundamental rights laid down in the treaties and in the Charter of fundamental rights of the Union without, in principle, any obstacle and within an environment governed by the rule of law. In comparison to the American Declaration of Independence (1776), one may say that in the European area the individual is entitled to the "pursuit of happiness".[371]"[372]

It is submitted that this approach fits best into Alexy's wide scope of principles, because it recognizes the conflict between national sovereignty and free movement as a balancing process instead of viewing the 'internal market' as an end result (without indicating how this end result will ultimately be achieved). Individuals and undertakings have a right to free movement in the internal market, but EU Member States also have a right to regulate within their domestic jurisdictions. Any restriction to economic liberty in cross-border situations is, in this approach, a *prima facie* infringement of the principles underlying the internal market. Again, in the words of Barents:

> "In more practical terms the single market concept requires the elimination of all obstacles to intra-Community movement, which means that all national measures which directly or indirectly, actually or potentially affect interstate economic intercourse (goods, services, capital, labour) are in principle prohibited.[373] As a consequence, based on the primacy and direct effect of Community law, the various freedoms of the EC Treaty are qualified as fundamental rights for all European citizens, the wide interpretation of which can be compared to that of fundamental

[370] Barents & Brinkhorst 2006, p 299. This view is shared by Harbo 2010, p 174, who states that the ECJ does not distinguish between human rights and fundamental freedoms: in its view both are fundamental rights.

[371] Footnote in original: "For the far-reaching implications of this essentially political philosophy on markets and competition, see R. Stürner, *Markt und Wettbewerb über alles? Gesellschaft und Recht im Fokus neoliberaler Marktideologie*, München, Beck, 2007."

[372] Barents 2011, p 54.

[373] Footnote in original: "Starting with Joined Cases 56 and 58/64, *Grundig-Consten* [1966] ECR 499 (competition) and Case 8/74, *Dassonville* [1974] ECR 837, para 5 (free movement of goods), later on extended, albeit with different formulas, to the other freedoms."

> rights laid down in national constitutions and international treaties. Together, these fundamental Community freedoms guarantee the constitutional right of citizens to economic freedom: the right to contract, to exploit property and to exercise a profession everywhere in the European Union. The basic philosophy of the single market, supplemented by the concept of European citizenship, is the freedom of movement in every respect, such as the right of individuals and companies to invest, to lend or to borrow capital, to work, to sell or to buy goods and services at any place in the European Union, according to their own preferences and without, in principle, any unjustified interference from national public or private law. "The principles of free movement of goods and freedom of competition, together with freedom of trade as a fundamental right, are general principles of Community law of which the Court ensures observance", according to the Court's case law.[374]"[375]

Articles 30, 34-35 and 110-112 TFEU (free movement of goods), Article 45 TFEU (freedom of movement for workers), 49 TFEU (freedom of establishment), 56 TFEU (freedom to provide services), Article 63 TFEU (free movement of capital and payments), and Article 21 TFEU (right to travel and reside freely in the EU) thus contain a *prima facie* prohibition of obstacles to the free movement of goods, persons, services and capital.[376] Article 18 TFEU contains a *prima facie* prohibition of discrimination on grounds of nationality. Article 49 TFEU contains *inter alia* a *prima facie* prohibition on grounds of the legal form of an establishment. These *prima facie* prohibitions will now be discussed.[377]

6.3 A prima facie prohibition of obstacles to free movement

The *prima facie* prohibition of obstacles to the free movement of goods, persons, services and capital is worked out in Articles 30, 34-35 and 110-112 TFEU (free movement of goods), Article 45 TFEU (freedom of movement for workers), 49 TFEU (freedom of establishment), 56 TFEU (freedom to provide services) and Article 63 TFEU (free movement of capital and payments). In addition, Article 21 TFEU guarantees the right of citizens of the European Union to move and reside freely within the territory of the Member States. Any 'restriction' of these liberties is *prima facie* prohibited. The approach taken by these fundamental freedoms is thus, in the words of Craíg and De Búrca, essentially negative and deregulatory.[378] It seems, therefore, useful to seek guidance from Alexy's 'principle of negative liberty' for defining the *prima facie* scope of the free movement provisions.

According to Alexy, the principle of negative liberty includes three sub-principles: i) a maximally high degree of freedom of action and non-interference with those actions, ii) a maximally high degree of non-interference with states of affairs, and iii) the maximum

[374] Footnote in original: "Case 240/83, *ADBHU* [1985] ECR 531, para 9."
[375] Barents 2011, p 55.
[376] Compare Article 3(1)(c) EC, replaced, in substance, by Articles 3 to 6 TFEU.
[377] It should be noted that there is a clear convergence of the free movement provisons in the ECJ's case law; see for example Case 48/75 Royer, § 23. Compare also Kapteyn & VerLoren van Themaat 2008, p 593 and Barnard 2010, p 236 and p 569-570.
[378] Craig & De Búrca 2008, p 606.

non-removal of legal positions. There should be no obstacles to the choice of actions. This choice is limited directly by prohibitions and commands and indirectly by an interference with a right-holder's state of affairs or legal position; as stated in section 4.3, the removal of a power has a limiting character. This implies that the right to liberty is affected if the choice of actions has been limited.[379]

The fact that the principle of negative liberty has three sub-principles makes it possible that freedom of action is affected in several ways within one single legal sub-system. This can be illustrated by taking tax law as an example. The imposition of taxes *prima facie* interferes with the right to liberty.[380] The command to pay taxes is a limit to the principle of free choice of actions. Within the tax system, however, subsequent limits may occur. These limits are often enshrined in rules which deviate from the 'normal' structure of the tax system. A rule in a tax system may, for example, prohibit the deduction of costs which are related to a felony although the income from that felony is taxable. This prohibition clearly limits the right to liberty further. Another example can be found in a rule which in certain situations limits the power granted to a corporate taxpayer to offset losses against future profits in situations of a 'change of control' of the taxpayer (new shareholders). This rule, which removes the general right of loss-compensation in situations which are deemed abusive, also functions as a second limit to liberty.

In the approach outlined above, direct taxation would in principle interfere with the EU free movement provisions insofar it concerns cross-border situations.[381] Obviously, this does not mean that direct tax rules can no longer be adopted: a wide scope of a principle implies a wide scope of its limits (see section 4.4).[382] In the large majority of cases, the principle of proportionality will not affect direct tax rules which are mainly aimed at collecting public resources. When an attempt is made to apply the proportionality test to a specific direct tax rule it becomes clear that such an application – although theoretically required – does not always have a practical effect. After all, the imposition of taxes for the collection of public resources should by definition be seen as a suitable and necessary means to achieve that aim.[383] The goal of collecting public funds is a respectful aim and too abstract to make a meaningful aim-and-means assessment in individual cases possible.[384] According to Tipke, the general aim of collecting public resources – as opposed to more specific policy rules – does not make it possible to carry out a proportionality test in the narrow sense.[385] Steenken has argued that the principle of proportionality is generally not

379 Alexy 2002, p 141, 225 and 230.

380 According to Wacke 1966, p 107, the general right to liberty implies a basic right to tax freedom. The EctHR takes the stance that taxation implies an infringement of the right to property protected by Article 1 of the First Protocol; see for instance the judgment of 23 October 1990, Application no. 11581/85, *Darby v. Sweden*.

381 See also Isenbaert 2010, p 494.

382 This means that the theoretical assessment model developed in the present study will not turn back the clock to the formula of Case 8/74 *Dassonville* and ignore the doctrine debeloped in Joined cases C-267/91 and C-268/91 *Keck and Mithouard*. See in more detail section 8.2.3.3 of the present study.

383 See Steenken 2002, p 32-33.

384 Papier 1983, p 649.

385 Tipke 1993, p 424.

capable of providing for limits – apart from the requirement that taxes should not have a confiscating effect – which the legislature has to observe when enacting direct tax rules which are mainly aimed at collecting public resources. If, however, the direct tax rules in question also pursue other goals which are aimed at influencing a taxpayer's behaviour, the principle of proportionality can play an important role. In these situations the rule has a clear motive – other than just collecting money – as a result of which a meaningful aim-and-means assessment in individual cases is possible.[386]

It will be discussed in chapter 7 in which cases the principle of proportionality can be applied in a meaningful way. First, we will turn to the *prima facie* requirements of the prohibition of discrimination on grounds of nationality which is laid down in Article 18 TFEU.

6.4 A prima facie prohibition of discrimination on grounds of nationality

Under Article 18 TFEU any discrimination on grounds of nationality shall be prohibited. This requirement has found specific expression in the free movement provisions.[387] Article 18 TFEU should be regarded as a principle and not as a rule in Alexy's sense, which will be explained later. Under Alexy's theory of principles, Article 18 TFEU must be given its widest possible scope in the light of its objectives. Two aspects catch the eye. In the first place, it has to be determined how the notion of 'nationality' as a ground of distinction has to be interpreted. In the second place, the question arises more generally of how a *prima facie* infringement of the principle of equal treatment should be determined. These aspects will now be discussed.

The first thing to be noted when talking about 'nationality' as a distinction ground is that rules which make a distinction on this basis are only *prima facie* prohibited. Erroneous is the view that differentiation on this ground is never acceptable, as a result of which it could never be substantively assessed for its reasonableness.[388] After all, principles can never be absolute (section 4.4). A distinction on grounds of nationality of a producer or a product (its origin) may in certain situations be regarded as perfectly acceptable, which makes it clear that Article 18 TFEU does not reflect a rule but a principle under Alexy's doctrine of collision (section 4.2).

A second thing to be noted is that 'nationality' as a distinction ground should not be interpreted narrowly, given the fact that the principle of non-discrimination shall be given its widest possible scope in the light of its objectives. Every rule which in fact discriminates on this ground should be caught by a *prima facie* prohibition.

A third thing to be noted is that 'nationality' as a distinction ground should be interpreted against the background of the aims of the internal market. It has been argued in section 6.2 that the internal market should be understood in terms of economic freedom of the

386 Steenken 2002, p 33-34, and the literature there referred to.

387 Article 21 TFEU (right to travel and reside freely in the EU), Articles 30 and 34-35 TFEU (free movement of goods), Article 45 TFEU (freedom of movement for workers), Article 49 TFEU (freedom of establishment), Article 56 TFEU (freedom to provide services) and Article 63 TFEU (free movement of capital and payments).

388 Gerards 2005, p 25, with further references.

individual. Every European citizen and legal person should be able to invest, produce, buy and offer services and products, borrow and lend capital and work anywhere in the Union, depending on the place where the economic conditions are the most favourable. Against this background the *prima facie* prohibition of discrimination on grounds of nationality supports the view that rules which make a distinction on grounds of cross-border activity are *prima facie* prohibited: if it is *prima facie* prohibited for the host State of a natural or legal person to discriminate on ground of nationality, it would be counterproductive if the home State were capable of frustrating this prohibition by discriminating against cross-border activity into the host State. We can see an interaction here with the *prima facie* prohibition of obstacles which has been discussed in the previous section.

The more general question of how a *prima facie* infringement of the principle of equal treatment should be determined relates to the method of finding a *prima facie* unequal treatment. It should be noted in this respect that the *prima facie* prohibition of discrimination on grounds of nationality reflects a so-called 'closed system': the legislative classification in question should be able to be linked to that specific ground. This poses, as already stated above, a number of problems.[389] Firstly, a distinction which is based directly on grounds of nationality is not always unreasonable. Secondly, it is problematic that a legislative classification which is not based on nationality may have serious adverse consequences for the group protected by the legislature. In order to deal with these problems, the concept of 'indirect distinction' is often used, for which usually a broad possibility for justification is accepted. Thus, any legislative classification which *in fact* makes a distinction on grounds of cross-border activity should pursue a respectful aim and be suitable, necessary and proportionate in relation to that aim.

6.5 A prima facie prohibition on grounds of the legal form of an establishment

According to Article 49 TFEU, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. This last prohibition grants to EU nationals and companies a *prima facie* right to freely choose the legal form for exercising their right to set up a secondary establishment in another Member State, i.e. a subsidiary or a branch. Tax measures which treat these legal forms differently should consequently be seen as a *prima facie* limit to the principle of free movement.

6.6 Conclusion

It has been argued in this chapter that the EU free movement provisions are principles in Alexy's sense, which means that they are optimization requirements rather than fixed rules. Free movement is, in other words, in no way absolute. Its extent should be determined in the context of a theoretical optimization model which will be outlined in chapter 7.

[389] Gerards 2004, 180-181.

The purpose of the present chapter has been to illustrate the *prima facie* position of the principle of free movement. This position has been examined without reference to the case law of the ECJ, because the widest scope of the free movement principle should be adopted according to Alexy's theory on the scope of principles. If the ECJ's case law were taken into account here, the theoretical optimization model which will be presented in the next chapter would become 'polluted' as a result of which it would no longer be possible to test the case law against that model (section 6.1).

It has been argued that the aims of the internal market are best perceived as a set of fundamental rights and freedoms which guarantee the economic freedom of the individual in cross-border situations. The purpose of these principles is to protect economic liberties from being restricted. The *prima facie* prohibitions of obstacles to free movement and discrimination on grounds of nationality or the legal form of an establishment should be defined against this background (section 6.2).

The scope of the *prima facie* prohibition of obstacles has been formulated by having recourse to Alexy's definition of the principle of negative liberty. This principle includes three sub-principles: i) a maximally high degree of freedom of action and non-interference with those actions, ii) a maximally high degree of non-interference with states of affairs, and iii) the maximum non-removal of legal positions. It has been argued that the right to liberty is affected if the choice of actions has been limited. The fact that the principle of negative liberty has three sub-principles makes it possible that freedom of action is affected in several ways within one single legal sub-system. For example, the imposition of taxes (a command) interferes with the right to liberty. Within the tax system subsequent limits may occur. These limits are often enshrined in rules which deviate from the normal structure of the tax system (section 6.3).

The definition of the *prima facie* prohibition of discrimination on grounds of nationality requires that the notion of 'nationality' is interpreted. Firstly, rules which make a distinction on this basis are only *prima facie* prohibited. Erroneous is the view that differentiation on this ground is never acceptable, and thus never be substantively assessed for its reasonableness. Secondly, 'nationality' as a distinction ground should not be interpreted narrowly. Every rule which in fact discriminates on this ground should be caught by a *prima facie* prohibition. Thirdly, 'nationality' as a distinction ground should be interpreted against the background of the aims of the internal market. Against this background the *prima facie* prohibition of discrimination on grounds of nationality supports the view that rules which make a distinction on grounds of cross-border activity are *prima facie* prohibited.

Article 49 TFEU also provides for a *prima facie* prohibition of restrictions of the choice of the legal form in which a natural or legal person wishes to establish himself in another Member State. Any legislative classification in this area should be open to proportionality analysis (section 6.5).

Chapters 5 and 6 have discussed the *prima facie* requirements of the principles of direct tax sovereignty and free movement. Chapter 7, to which we shall now turn, will provide a theoretical optimization model to resolve the conflict between those principles.

7. A theoretical optimization model for direct taxation cases

7.1 Introduction

The purpose of this chapter is to apply Alexy's theory of principles as optimization requirements (see chapter 4) to the principles of direct tax sovereignty (chapter 5) and free movement (chapter 6) in order to formulate a theoretical optimization model. This model is external to and independent of the ECJ's current case law. As such it is able to serve as an objective framework which can be used to assess whether the ECJ's case law in the area of direct taxation and free movement strikes a fair balance between the competing principles or not. In this respect, the model makes a normative claim. It should be stressed that this study does not claim that the theoretical assessment model arrived at necessitates only one solution in an individual case.[390] Rather, the model prescribes the method through which the problem should be solved, thus limiting the number of possible outcomes and structuring the analysis in a coherent manner. As Von Bogdandy has rightfully stated:

> "it should be noted that there is one function that a legal doctrine of principles cannot usually fulfil: to delimit right and wrong in a concrete case. This is a result of the general vagueness of principles; the conflict usually arising when different principles are applied to concrete facts is another reason. The solution to a conflict of principles cannot be determined either scientifically or legally, it can only be structured."[391]

It will become clear in chapter 8 that the model also makes a descriptive claim in the sense that it helps to describe the ECJ's case law and the conclusions reached therein.

I was definitely not the first to think of the possibility of linking Alexy's theory of principles to the conflict of principles in the EU legal order (see chapter 3). Bengoetxea, MacCormick and Moral Soriano, for instance, have argued that the ECJ should not formulate a systematic order of principles, but should rather promote all of them (demand of proportionality). According to these authors, the ECJ understands proportionality in Alexy's sense: as a command to optimize - that is, as a command to find an equilibrium among all colliding interests and values.[392] Andenas and Zleptnig have reached similar conclusions with respect to WTO law.[393] This chapter takes these observations one step

[390] Compare Vanistendael 1991, p 225.
[391] Compare Von Bogdandy 2010, p 101.
[392] Bengoetxea, MacCormick & Moral Soriano 2001, p 76.
[393] Andenas & Zleptnig 2007, p 376-379.

further and aims at formulating a theoretical optimization model on the basis of Alexy's theory. This model will be expressed in section 7.2. Subsequent sections will comment on its various phases.

7.2 The theoretical optimization model

Based on the results presented in chapters 4, 5 and 6, the theoretical model for the optimization of the principles of direct tax sovereignty and free movement is phrased as follows.[394]

1. To which *disadvantage* does the tax measure lead?
2. Does the tax measure at issue have a *respectful aim*?
3. If yes, is the tax measure *suitable* to achieve its aim?
4. If yes, does the tax measure have a sufficient *degree of fit* in relation to its aim?
5. If yes, does the tax measure reflect the most *subsidiary* means to achieve its aim?
6. If yes, is the cost to free movement caused by the tax measure *in proportion* to the aims pursued by it?

A tax measure can be allowed only if all questions are answered positively; they are cumulative requirements. The issue of whether these questions should be answered *ex tunc* or *ex nunc* depends on the type of legal procedure. In cases concerning a preliminary reference by a national tax court to the ECJ, the answers should be provided *ex tunc*, because this procedure concerns a tax assessment which has been issued in the past. In cases concerning an infringement procedure initiated by the Commission, the questions should be answered *ex nunc*, because such a procedure concerns the assessment of domestic legislation as it currently stands.

Gerards has argued that the model should be preceded by a preliminary phase where the level of intensity of the review should be determined.[395] This level could be either marginal, neutral or intensive. I have decided not to formally include such a preliminary phase for the purposes of the present study. The conflict between the principles of direct tax sovereignty and free movement in the vast majority of cases concerns distinctions on grounds of cross-border (economic) activity: indirect discriminations on grounds of nationality and other obstacles to free movement. There is no need to apply different levels of review intensity for those similar cases. However, a higher level of intensity may have to be applied to the rare cases where a distinction is based directly on a suspicious ground such as the nationality of the taxpayer. A lower level of intensity may have to be applied with regard to tax measures without a very precise aim such as 'equitable taxation' (e.g. progressive tax rates). These specific issues will be dealt with in the next sections where appropriate.

[394] J.H. Gerards has developed a similar model for the principle of equality; see the summary in Gerards 2005, p 99-102 and p 711-718, The model in the present study focuses on the principle of free movement.

[395] Gerards 2004a and Gerards 2005, p 79 et seq. See also Rivers 2006.

7.3 Disadvantage identification[396]

7.3.1 Why a 'disadvantage' test?

Both tax sovereignty and the EU free movement provisions have to be regarded as principles rather than rules (see sections 5.1 and 6.1). They are optimization requirements and should be realized to the greatest extent legally and factually possible. Their extent is therefore in concrete cases determined by competing rules and principles; they cannot determine their own extent. In order to achieve the optimum between competing principles it is necessary that their widest possible scope is adopted at the beginning of the optimization process. After all, if a narrow scope were adopted this would mean that no fine-tuned optimization is possible any more (see sections 4.2 and 4.3). The *prima facie* position of the principle of tax sovereignty is a general freedom of action of States, as limited by international law. The *prima facie* position of the principle of EU free movement is a general freedom of action of (economic) actors, which should not be hindered by tax measures which discriminate on grounds of cross-border activity or legal form, nor by any other tax obstacles. This means that any act on the basis of tax sovereignty implies a *prima facie* infringement of the principle of free movement (and *vice versa*).

Of course, the result of the optimization process which follows should not be that taxation *as such* would no longer be possible.[397] Nor should the result be that free movement would be cancelled out altogether. Neither principle should cancel out the other (sections 4.5.2 and 4.6). Thus, a claim or *petitum* of the taxpayer which in fact implies a request for abandoning direct taxes as such cannot ultimately be sustained, because it would deny the existence of a State's direct tax sovereignty. This will be explained in more detail in section 7.4.2. However, a claim in respect of taxation which is so burdensome that free movement would be rendered practically meaningless – e.g. a marginal tax rate of 95% or the absence of an appropriate freedom of movement for the development of economic activities should not be rejected at the outset, because such a rate could be disrespectful towards the principle of tax sovereignty.

Whether a tax measure will be allowed to stand in a concrete situation should *not* be verified in the first phase of the theoretical optimization model, but rather in all its subsequent phases (it follows from the nature of principles that the threshold for optimization is kept as low as possible). Indeed, Gerards has convincingly argued that, with respect to the principle of equality, it is not necessary to examine whether comparability exists in the first level of assessment.[398] The present study follows a similar approach.

The first phase thus merely serves to identify to which disadvantage a certain direct tax measure leads. A court should be able to verify the *petitum* or claim of the taxpayer: which amount of tax should be refunded in the event that the court found in favour of the taxpayer?[399] This is all that the first phase is concerned about; I will explain this in more detail in section 7.3.2.

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396 A prominent advocate of this test is J.H. Gerards; see Gerards 2005, p 76-79, and p 669 et seq.
397 Compare Cordewener 2002, p 847.
398 Gerards 2005, p 76-79.
399 Gerards 2005, p 76.

It is, however, necessary to examine in this first phase whether the disadvantage in question results from a disparity, because such a disadvantage is outside the theoretical optimization model (section 7.3.3).

I will now give some examples of the various 'disadvantages'.

7.3.2 Disadvantages: some examples

Introduction

The EU free movement provisions contain three *prima facie* positions: a *prima facie* prohibition of discrimination on grounds of cross-border (economic) activity, a *prima facie* prohibition of discrimination on grounds of the legal form of an establishment, and a *prima facie* prohibition of obstacles to free movement (a general freedom of action of (economic) actors). The last *prima facie* position includes the other two. First, these two will be discussed very briefly. Subsequently, some examples of other tax obstacles will be provided.

Disadvantageous treatment of cross-border movement

Legislative classifications on grounds of cross-border movement should be seen as a *prima facie* limit to the principle of free movement (section 6.4). In addition, any legislative classification which has the effect of discriminating against nationals of other EU Member States should qualify as a *prima facie* discrimination on grounds of nationality. In these cases there is a disadvantage for the taxpayer in comparison with a taxpayer who has the nationality of the Member State concerned.

Disadvantageous treatment of one legal form versus another

Tax measures which treat subsidiaries and branches differently in the context of freedom of establishment serve as a *prima facie* limit to the principle of free movement (section 6.5). In these cases there is a disadvantage for the taxpayer in comparison with the other legal form.

Non-discriminatory tax obstacles to free movement: basic tax rules

In section 6.3 the position has been defended that direct tax measures *as such* function as a *prima facie* limit to free movement. The benchmark in that respect is the situation in which there is no tax measure left which applies to the situation of the taxpayer. This is indeed a 'disadvantage' within the meaning of phase 1 of the theoretical optimization model. Needless to say, this does not at all mean that direct tax measures which form the backbone of an income tax system – the definition of taxable persons, taxable income, the tax rate, depreciation rules, rules on loss carry-overs, etcetera – will ultimately be illegal. This will be discussed in the subsequent phases of the model.

International juridical double taxation

A taxpayer may also put forward that he has suffered a disadvantage as a result of the fact that he has been exposed to direct taxation in two (or more) States in respect of the same income. In such a case, the 'disadvantage' is caused by the refusal to provide for the avoidance of double taxation.

Non-discriminatory tax obstacles to free movement: tax rules with a specific objective
Here, one can think of rules which make amendments to the basic structure of a tax system in order to discourage certain behaviour. These rules may for instance be targeted at countering tax avoidance. This can also be explained by bringing to mind that the principle of negative liberty includes three sub-principles: i) a maximally high degree of freedom of action and non-interference with those actions, ii) a maximally high degree of non-interference with states of affairs, and iii) the maximum non-removal of legal positions. This makes it possible that freedom of action is affected in several ways within one single legal sub-system (section 6.3). Within a tax system, which *prima facie* limits the principle of negative liberty, subsequent limits may occur in the form of additional commands or a removal of powers. Rules which are aimed at countering tax avoidance have this effect. An example is a rule which in certain situations limits the power granted to a corporate taxpayer to offset losses against future profits. This rule, which removes the general right of loss-compensation in situations which are deemed abusive, functions as a second limit to liberty. Another example can be found in CFC-legislation which – if the classification of abusive conduct is overinclusive – in fact results in an extra command to pay taxes. In these cases the taxpayer suffers a disadvantage relative to the 'normal' structure of the tax system.

Non-discriminatory tax obstacles to free movement: tax penalties
Another example concerns measures of general economic policy aimed at spending money to encourage certain behaviour or at discouraging certain behaviour by imposing a special burden on a product of a producer (see section 5.4.3). A tax penalty departs from the normative income tax by requiring a greater tax payment than would occur but for the measure which imposes the penalty, thereby increasing the taxpayer's tax burden. An example of tax penalties in income taxes can be found in various 'public policy' provisions that deny deductions for certain business expenses involving lobbying, bribes, or fines.[400] Also in these cases the taxpayer suffers a disadvantage relative to the 'normal' structure of the tax system.

Non-discriminatory tax obstacles to free movement: tax rules which are disproportionate within the narrow meaning of that term
The taxpayer may also claim that the tax measure at issue is disproportionate within the narrow meaning of that term: the cost to free movement caused by the tax measure is not *in proportion* to the objectives pursued by it. This may for instance be the case if the taxation at issue is so burdensome that free movement would be rendered practically impossible – e.g. a marginal tax rate of 95% or the absence of an appropriate freedom of movement for the development of economic activities. In such a case, the disadvantage reclaimed by the taxpayer concerns the difference between the current level of taxation and a level at which his income is no longer taxed at a level which is disproportionate.[401]

[400] Infanti 2005, footnote 60, with further references.
[401] Compare Cordewener 2002, p 855-856.

7.3.3 Disparities

The theoretical optimization model can only be applied in relation to tax measures which have been adopted by the Member State which is accused of restricting free movement. This is due to the fact that the theoretical optimization model deals with the conflict between the principles of direct tax sovereignty and free movement. Such a conflict is absent in the event that the Member State concerned is reproached with the fact that another Member State has a different tax system (e.g. a lower tax rate). These situations are therefore outside the scope of the theoretical optimization model. An example may clarify this. If a taxpayer complains in Member State A that he would have been taxed at a lower tax rate if Member State B would have taxed him, which results in unequal treatment in the internal market, the theoretical optimization model does not apply. The conflict between the taxpayer and Member State A – a conflict between EU free movement and the tax sovereignty of Member State A – is not affected by the tax sovereignty of Member State B. In other words, there is no collision of principles if such a claim is made.

7.3.4 Conclusions

In this section, it has been argued that the first phase of the theoretical optimization model merely serves to identify the disadvantage in question: which amount of tax should be refunded in the case that the court would find in favour of the taxpayer? Although direct taxation *as such* will not ultimately give rise to a prohibited restriction on free movement, provided that the taxation at issue does not render free movement illusionary, the question of how a certain tax measure should be optimized in view of the principle of free movement should *not* be verified in the first phase of the theoretical optimization model, but rather in all its subsequent phases (it follows from the nature of principles that the threshold for optimization is kept as low as possible). It is clear in phase 1 of the model, however, that any disadvantage due to disparities in the tax systems of Member States are outside the scope of the theoretical optimization model, because in these cases there is no conflict between the principles of direct tax sovereignty and free movement.

7.4 The requirement of a respectful aim

7.4.1 The idea of a twofold neutrality

A norm can only serve as a limit to a restricted principle if it has a 'respectful aim' (section 4.5.2). A limit does not have a respectful aim if it has no other objective than limiting that principle. Conversely, a restricted principle does not have a respectful aim if it does not accept that it may be limited. In both cases, the principle and limit do not 'respect' each other. I have argued in section 4.5.2 that no other requirements may be imposed, apart from being formally and substantively compatible with other principles with a similar status such as enshrined in the TEU and the TFEU.

The impact of this definition for the conflict between the principles of direct tax sovereignty and free movement is the following. First, the view is erroneous that differentiation on grounds of nationality is never acceptable. Principles can never be

absolute and a distinction on grounds of nationality of a producer or a product (its origin) may in certain situations be regarded as perfectly acceptable (section 6.4). Second, if it is accepted that EU Member States have, in principle, retained their sovereignty in the field of direct taxation, the application of the principle of free movement should, in principle, be neutral towards the internal and external objectives pursued by a national tax system and the way in which inter-nation equity is achieved by the Member States. The fundamental choices made in this area should be respected. On the other hand, these choices should be neutral in regard to free movement. AG Poiares Maduro has made this point very clearly in his landmark opinion in *Marks & Spencer*: In his view, the Member States clearly have a legitimate interest in ensuring the integrity and the equity of their tax systems. According to Poiares Maduro this does not mean, however, that this concept can be used as an argument to be deployed against the objectives pursued in the context of the internal market. It cannot be accepted that a tax system be arranged in such a way as to favour national situations or traders. According to Poiares Maduro, the "delicate nature of this equilibrium" may be conveyed by the idea of "twofold neutrality" which he describes as follows:

> "On the one hand, the national tax rules must be neutral in regard to the exercise of the freedoms of movement. In that connection, it should be recalled that Article 43 EC lays down a requirement of fiscal neutrality in regard to the establishment of undertakings in the Community. On the other hand, the exercise of the freedoms of movement must be as neutral as possible in regard to the tax arrangements adopted by the Member States."[402]

This idea of a 'twofold neutrality' means that direct tax measures should have an objective which is unrelated to the effect of the measure (i.e. an unequal tax treatment of domestic and cross-border situations or a general limitation on economic liberty). In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. Isenbaert has made a somewhat similar point, arguing that the normative aspect of the theory of constitutional pluralism (see section 5.1 of the present study) implies one principle external limitation to the interpretative autonomy of the ECJ: the core functions and objectives of the policy areas in which the Member States have retained their (function-)sovereignty. Isenbaert states that if it is accepted that there is no conceptual hierarchy between the 'sovereignty' claims of the Union and the Member States, it must necessarily also be accepted that both should allow each other to pursue the objectives and to perform the functions which are inherent to the policy areas which have remained with their function-sovereignty. As a result, Isenbaert argues, the rules coordinating the limits to the exercise of authority by either the Union or the Member States must necessarily be found in the core functions and objectives of the policy areas over which the other has remained function-sovereign.[403]

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402 Case C-446/03 *Marks & Spencer*, § 66-67.

403 Isenbaert 2010, p 226-227.

It is, therefore, important to examine which objectives tax systems have.[404] Although there is no conceptual difference in the analysis of rules with internal and external objectives respectively, it is useful to distinguish between the two for illustration purposes. First, I will explain why taxation *as such* has a respectful aim and why an EU Member State has no obligation to provide for the avoidance of international juridical double taxation.

7.4.2 Taxation as such

The notion of a 'twofold neutrality' means that the principle of free movement should respect direct tax measures which form the backbone of an income tax system, such as the definition of taxable persons, taxable income, the tax rate, depreciation rules, rules on loss carry-overs, etcetera. Such respect would be absent if the principle of free movement were to set aside tax sovereignty *as such*, because it would not recognize tax sovereignty as its limit. This means that the goal of collecting public funds is a respectful aim. Generally, this objective is too abstract to make a meaningful aim-and-means assessment in individual cases possible. It has been argued in section 6.3 that the imposition of taxes for the collection of public resources should be seen as a suitable (phase 3) and necessary (phases 4 and 5) means to achieve that aim. The principle of proportionality is generally not capable of providing for limits which the legislature has to observe when enacting direct tax rules which are mainly aimed at collecting public resources, except in the case of a disproportionate infringement of the principle of free movement (phase 6).

I have considered the possibility of introducing a 'but for' test in phase 1 of the model as a result of the above-mentioned observations: a restriction of free movement would exist whenever the activity concerned would have been taxed under a less burdensome tax rule BUT FOR the tax measure considered. The 'but for' test would make it possible to calculate the tax due *without the measure at issue* in a meaningful way. In addition, it would acknowledge that taxation *as such* should not be regarded as a restriction of free movement. Thus, the idea of a 'twofold neutrality' is duly respected in the sense that neither of the two competing principles would cancel out the other. In my view, a 'but for' test would be a useful tool for identifying disadvantages in (corporate) income tax systems, because these systems will normally have rules which define their backbone rules on taxable persons, taxable income, the tax rate, etcetera. Measures which have other objectives which can be subject to proportionality analysis can be identified by a 'but for' test.[405] Nevertheless, I have finally decided not to include a 'but for' test in the model for two reasons. First, a 'but for' test would filter out in the first phase of the model tax rules which make the exercise of the principle of free movement almost impossible (e.g. extremely high tax rates), where these rules should be able to be examined for their proportionality in the narrow meaning of the term. Second, the 'but for' test has already been used in the area of State aid law, but not entirely without difficulty. It is settled ECJ case law that the concept of aid may cover not only positive benefits, such as subsidies, loans or the taking of shares in undertakings, but also action which, in various forms, mitigates the charges which are normally included

[404] See section 4.5.2 on how to establish the objective of a measure and on how to deal with a plurality of objectives.

[405] Compare Douma & Engelen 2010.

in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect. Furthermore, a measure by which the public authorities grant to certain undertakings a tax exemption which places the persons to whom it applies in a more favourable financial situation than other taxpayers constitutes State aid.[406] The very existence of an advantage may be established only when compared with 'normal' taxation.[407] The application of a 'but for' test has already been subject to some debate under WTO law (the Agreement on Subsidies and Countervailing Measures). For the purpose of that Agreement, a subsidy *inter alia* exists if "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)" (Article 1.1 of the Agreement). In *US - FSC*, the Appellate Body, interpreting the phrase "foregoing of revenue otherwise due", partly agreed with the Panel's interpretation that the term "otherwise" referred to a "normative benchmark" as established by the tax rules applied by the Member in question. The Appellate Body rejected the use of a benchmark other than the tax rules of the Member in question, holding that to do otherwise would be contrary to a Member's sovereignty of taxation:

> "In our view, the '*foregoing*' of revenue '*otherwise due*' implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, 'otherwise'. Moreover, the word 'foregone' suggests that the government has given up an entitlement to raise revenue that it could 'otherwise' have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax all revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise'. We, therefore, agree with the Panel that the term 'otherwise due' implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. To accept the argument of the United States that the comparator in determining what is 'otherwise due' should be something other than the prevailing domestic standard of the Member in question would be to imply that WTO obligations somehow compel Members to choose a particular kind of tax system; this is not so. A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations. What is 'otherwise due', therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself."[408]

This clearly reflects the notion of a 'respectful aim', because the Appellate Body emphasizes, first, that a court should respect the basic choices made by a State in the exercise of its tax

[406] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission*, § 86-87.
[407] Case C-88/03 *Portugal v. Commission (Azores case)*, § 56.
[408] Appellate Body Report of 24 February 2000 in the case *United States – Foreign Sales Corporations*, AB 1999-9, § 90.

sovereignty and, second, that this State in turn has to respect its WTO obligations when exercising its tax sovereignty. The Appellate Body on *US - FSC* subsequently expressed some reservations about the Panel's 'but for' test:

> "The Panel found that the term "otherwise due" establishes a "but for" test, in terms of which the appropriate basis of comparison for determining whether revenues are "otherwise due" is "the situation that would prevail but for the measures in question". In the present case, this legal standard provides a sound basis for comparison because it is not difficult to establish in what way the foreign-source income of an FSC would be taxed "but for" the contested measure. However, we have certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language. Moreover, we would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases."[409]

These reservations of the Appellate Body in respect of a 'but for' test show concerns that Member States may become too 'clever' and be provoked to design their tax systems in such a way that no alternative rule at all would apply but for a certain tax measure. Here, one could think of separate taxes for different sectors or activities. In order not to get lost in this discussion, I have concluded that it would be better not to include a 'but for' test in the first phase of the model, but rather to apply the model as a whole to every tax rule which causes an identifiable 'disadvantage'. This may, therefore, also concern taxation as such: a disadvantage compared to zero taxation.

7.4.3 International juridical double taxation

In the case that a disadvantage arises as a result of the fact that a taxpayer is exposed to direct taxation in two (or more) States in respect of the same income, the question arises of whether one of those States should provide for the avoidance of double taxation. In the framework of the development of a theoretical optimization model, the question specifically arises of whether the absence of such a provision – and consequently full taxation in both States on the same income – can be meaningfully assessed in such a model. It is submitted that this question should be answered negatively. The claim of the taxpayer essentially entails that a State should refrain from taxing income within its tax jurisdiction. The level of taxation 'but for' the tax measure at issue would, therefore, be zero. If the principle of free movement were to support this result, it would be disrespectful

[409] Appellate Body Report of 24 February 2000 in the case *United States – Foreign Sales Corporations*, AB 1999-9, § 91. These reservations were reiterated by Appellate Body Report of 14 January 2002 on *US — FSC (Article 21.5 — EC)*, AB-2001-8, § 91.

towards tax sovereignty – the aim to raise revenue for the State cannot be achieved by the tax laws of another State. As a consequence, the principle of free movement would not be respectful towards the principle of direct tax sovereignty if it were to oblige a State to refrain from taxation once another State has already taxed the income. It would deny the very existence of direct tax sovereignty.

International juridical double taxation arises as a result of the simultaneous application by States of nationality, residence and source as criteria to define their tax jurisdiction. International juridical double taxation would not occur if all States used the same single criterion. Consequently, the question arises as to whether the principle of free movement may prescribe that a Member State uses only one criterion to define its tax jurisdiction on the ground that only in that scenario can the Member State not be accused of contributing to international juridical double taxation.[410] In my view, this would not be respectful towards the principle of direct tax sovereignty which *prima facie* requires that a State is maximally free to adopt – within its domestic jurisdiction – measures of general tax and economic policy and to determine the objectives it wants to pursue through these measures (sections 5.3 and 5.4). In turn, the objective of the absence of rules for the avoidance of international juridical double taxation is not to limit free movement but to raise taxes in the tax jurisdiction of the Member State concerned. This means that the absence of these rules does not pursue a disrespectful objective.

7.4.4 General measures of tax policy

'Internal' measures aimed at collecting resources for the State may have as their sub-goal to do this in a manner which is perceived as fair (tax rates may, for instance, have a progressive scale, groups of companies may be taxed on a consolidated basis, measures may be aimed at avoiding economic double taxation, etcetera). Further sub-goals may be aimed at granting a certain form of equitable treatment only to resident taxpayers (e.g. the prevention of economic double taxation only for resident taxpayers or taxation of income on a net basis only for resident taxpayers). Clearly, rules which implement these further sub-goals are a limit to free movement. They can only be regarded as 'respectful' if they can be justified on other grounds than tax sovereignty itself (a principle cannot determine its own extent; see sections 4.5.2). Budgetary reasons cannot, therefore, be regarded as respectful. If it were otherwise, the extent of tax sovereignty would be unlimited and absolute. Rules which are targeted at countering tax avoidance clearly have a respectful objective, because these anti-abuse rules are not aimed at limiting free movement and the principle of free movement has to respect the need of the principle of tax sovereignty to collect taxes.[411] Anti-abuse

[410] This is known as the 'internal consistency' test which has been advocated *inter alia* by Kofler & Mason 2007.

[411] Measures aimed at influencing a taxpayer's behaviour normally have a clear objective which makes it possible to perform proportionality analysis without disrespecting the underlying principles of direct tax sovereignty. The objective of preventing tax avoidance by an individual taxpayer can be fully respected by the principle of free movement under proportionality analysis, because the tests of suitability and necessity are factual – not normative – tests (see paragraphs 4.5.3 and 4.5.4). The function of proportionality analysis in these cases is to make sure that the measures are actually suitable and necessary to achieve these objectives. In particular, it can be

measures which apply solely because a taxpayer has established itself in another Member State with a low effective tax rate do however disrespect the principle of free movement, because these measures negate the very existence of a competing principle (the principle of free movement).[412] The *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction (sections 5.3 and 5.4) can, however, serve as a limit to free movement, because the principle of free movement has to be respectful towards the principle of tax sovereignty, too.

An example is provided by rules which are aimed at achieving taxpayer equity. These rules may either relieve the pressure on liberty by providing for an exemption of income from the taxable base or another form of mitigation (e.g. rules aimed at mitigating economic double taxation of dividends or a special deduction related to the personal circumstances of the taxpayer), or they may increase the pressure on liberty (e.g. by a progressive income tax rate). A taxpayer may take the position that the difference between the highest and the lowest marginal income tax rate constitutes a 'disadvantage' which needs to be refunded. Such a claim would however negate the fact that the principle of direct tax sovereignty *prima facie* requires that a State is maximally free to adopt measures of general tax and economic policy and to determine the objectives it want to pursue through these measures. The pursuit of taxpayer equity is one of these objectives. The principle of free movement has to respect this aspect of the principle of direct tax sovereignty (the requirement of a respectful aim). It cannot, therefore, impose a concept of its own of reasonable and correct law-making.[413] This is a result of the idea that principles cannot determine their own extent (section 4.2) and that the notion of taxpayer equity is too abstract to make a meaningful subsequent proportionality analysis possible. Therefore, the principle of free movement has to recognize the principle of direct tax sovereignty as a limit in this area.

Another example is provided by a system of group contribution which does not allow a company resident in the Member State concerned to make a deductible group contribution to its foreign parent company (see Case C-231/05 *Oy AA*). The primary goal of such a system is structural in nature: the collection of resources for the State. The sub-goal of the measure is to do so in an equitable fashion and to give groups of companies the possibility to have profits taxed at the level of the best-placed group company by making a tax deductible contribution of profits by one group company to another group company in the hands of which the profits are then taxed. This makes it, among others, possible that losses within a group of companies can be used to offset profits made by the group. A further sub-goal of such a group contribution regime is that the primary goal – collecting resources for the State – is not jeopardized by the first sub-goal (equitable taxation), as a result of which the possibility of making group contributions is limited to domestic group companies (the extension of the group contribution regime cross-border would mean that groups of companies would be allowed to choose freely the Member State in which the profits of the group company are to be taxed). If the principle of free movement were to

examined without harming the principle of direct tax sovereignty whether the measures taken have a reasonable degree of fit (the test of under- and overinclusiveness; see phase 4 of the model).

412 Compare Case C-196/04 *Cadbury Schweppes*, § 48-50.

413 Compare in this respect Case C-132/88 *Commission v. Greece*, § 16-17.

force the Member State concerned to extend its group contribution regime cross-border, it would in fact deprive that Member State of the right to regulate within its domestic jurisdiction (it would no longer be possible to tax the profits which are under international tax law attributable to that Member State; compare sections 5.3 and 5.5). Therefore, the principle of free movement has to recognize the principle of tax sovereignty as a limit in such a situation. If it would not do so, it would be disrespectful.

This example of disrespect of the principle of free movement can be contrasted with a system such as the one at issue in Case C-319/02 *Manninen*. This case concerned Finnish legislation whereby Finland granted a full imputation tax credit to Finnish shareholders in respect of Finnish corporate income tax levied on profits distributed as dividends. No tax credit in respect of foreign corporate income tax levied on foreign-source profits distributed as dividends was, however, granted. The ECJ held that free movement of capital requires Finland to extend this tax credit to account for corporate income tax levied on dividends from another Member State. The objective of the rule which limited the imputation credit to Finnish corporation tax was purely budgetary in nature. As such, it has to be regarded as disrespectful towards the principle of free movement. In contrast to *Oy AA*, we are not dealing with a situation where it would become impossible to levy an income tax on dividends within its tax jurisdiction, because the extension of the tax credit to cross-border situations will not result in a situation where paying income tax in Finland becomes voluntary. In other words, in *Oy AA* taxation *as such* was at stake, whereas in *Manninen* income tax could still be levied depending on the amount of foreign corporation tax attributable to the dividend, which is a logical end result in view of the overarching objective of the system (avoidance of economic double taxation).

The *prima facie* right of a State to be able to determine the organization and aims of the tax system within its domestic jurisdiction may also serve as a limit to free movement. An example is provided by a rule in a tax treaty which states that losses of a foreign permanent establishment can only be taken into account locally and are not deductible in the residence State at the level of the head office. The effect of such a rule is that undertakings in the source State are treated equally, regardless of their legal form (a legal person or a permanent establishment). Thus, the tax treaty rule makes sure that there is no interference by the State of the head office in the domestic jurisdiction of the State of the permanent establishment. This objective is not disrespectful towards free movement. On the contrary, free movement would be disrespectful towards the principle of tax sovereignty if it were to take away the right of another State to regulate direct taxation in its own domestic jurisdiction (compare section 5.3).

Other objectives which may serve as a limit to the principle of free movement include, for example, the need to prevent tax avoidance. But as stated, every thinkable rule may serve as a limit as long as it is respectful towards free movement.

7.4.5 General measures of economic policy

Rules which have an *external* objective – tax penalties and tax preferences – have two specific features in comparison with rules which have an internal objective. In the first place, a measure which, for example, encourages domestic investment cannot be regarded as respectful towards the principle of free movement on grounds of inter-nation equity or

the *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction. The reason for this is that the principle of free movement does not disrespect the principle of direct tax sovereignty if it requires that the rules with 'external' objectives be extended to cross-border situations. After all, such an extension would not have as its result that the Member State concerned can no longer tax the profits which are under international tax law attributable to that Member State, because taxation is not the underlying objective of tax preferences at all. An example of a discriminatory tax measure concerns a tax credit for research and development activities carried out on the national territory. This external goal cannot be justified on 'internal' grounds such as inter-nation equity.[414]

In the second place, external objectives may more easily than internal objectives run against the requirement that limits to the principle of free movement in this area should formally and substantively be compatible with other principles with a similar status. This means that these limits also have to abide by other requirements than free movement which the TEU and the TFEU contain.

7.4.6 Conclusion

The objective of a tax measure which leads to a certain identified disadvantage should be respectful towards the principle of free movement. *Vice versa*, the principle of free movement should respect the principle of direct tax sovereignty. This idea of a 'twofold neutrality' means that direct tax measures should have an objective which is unrelated to the effect of the measure (i.e. an unequal tax treatment of domestic and cross-border situations or a general limitation on economic liberty). If a certain measure does not have a stated credible objective, it should be assumed that its objective coincides with its effects. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. As a result, taxation is not *as such* disrespectful towards free movement. This may be different with respect to tax measures which pursue a specific objective. Although there is no conceptual difference in the analysis of rules with internal and external objectives respectively, it is useful to distinguish between the two for illustration purposes.

Tax measures with an 'internal' aim which lead to a certain disadvantage are not respectful towards free movement if the reason for that disadvantage is of a budgetary nature (the principle of direct tax sovereignty cannot determine its own extent). The same is true for anti-abuse measures which apply solely because a taxpayer has established itself in another Member State with a low effective tax rate. The *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction can, however, serve as a limit to free movement.

Tax measures with an 'external' aim which lead to a certain disadvantage have two specific features in comparison with rules which have an internal objective. In the first place, 'internal' grounds of inter-nation equity or the *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction may not be

[414] Compare Case C-39/04 *Laboratoires Fournier.*

able to serve as a credible reason for the alleged disadvantage. In the second place, external objectives may more easily than internal objectives run against the requirement that they also have to abide by other requirements than free movement which the TEU and the TFEU contain.

We will now turn to the third phase of the theoretical optimization model: the test of suitability'.

7.5 Suitability

The requirement of suitability is of an empirical nature (section 4.5.3). It entails an optimization requirement relative to what is factually possible (as opposed to what is legally possible).[415] Once it has been ascertained that a measure which causes a disadvantage has a respectful objective, it should be assessed, factually, whether the measures is apt to attain its objective. For example, a rule which exempts positive and negative income from a permanent establishment and consequently leads to a disadvantage in case losses can be attributed to the permanent establishment, is a suitable means to achieve its aim of internation equity.

7.6 Over- and underinclusiveness, or the assessment of the degree of fit

The assessment of the over- and/or underinclusiveness of a legislative classification relates to the degree to which the definition of a classification matches the aim of the measure (section 4.5.4). Tax measures which are, for instance, targeted at influencing the behaviour of individual taxpayers, thereby interfering with the right to liberty of the taxpayer on a second level (see section 7.3), lead to a specific interference with the principle of free movement. This makes it possible to conduct a very specific examination of the degree of fit; a precise aim enables a precise assessment of the degree of fit. However, in respect of measures of general tax policy aimed at achieving taxpayer equity – and not so much at influencing the behaviour of individual taxpayers – the Member State should have a wide margin of discretion. In such a case, the aim of the legislative classification is to levy tax in an equitable manner. Such an imprecise aim only allows for a marginal assessment of the degree of fit of that legislative classification. After all, the principle of free movement cannot impose a concept of its own of reasonable and correct law-making (section 7.4.4). In respect of tax measures which have another objective, a more precise scrutiny is possible as regards the degree of fit of the measure. In these situations an assessment of the relation between aim and means is possible.

7.7 Subsidiarity

The requirement of subsidiarity does not address the way in which the classification is defined (i.e. the degree of fit of a measure), but relates to the choice of the classification as a means to achieve the intended goal. The subsidiarity test examines whether it was actually necessary to make a distinction, aside from the question as to how this distinction

[415] Alexy 2002, p 67.

is actually defined.[416] Thus, the requirement of subsidiarity does not take the classification of the contested measure as a given, but requires that the court more or less independently investigates the available alternatives which are equally suitable to achieve the objective pursued. This investigation runs the risk of coming into the territory of proportionality in the narrow sense of the word, i.e. in the realm of what is legally possible as opposed to what is factually possible. Firstly, an alternative measure which could lead to the same objective may not in fact guarantee the same level of protection of the interests pursued. This is what Jans means when he states that the ECJ is prepared not to test the necessity of a measure at all if the measure is sufficiently sensitive.[417] Secondly, an alternative measure may introduce conflicts with other principles. For instance, the financial costs of an alternative measure may considerably higher, which makes a balancing exercise necessary.[418] Thirdly, an alternative measure may run the risk of not meeting the objective pursued altogether. This can be explained by giving the example of *Marks & Spencer*, the UK case on cross-border loss relief.[419] Why did the ECJ not require the UK to introduce a system of cross-border group relief for losses of EU subsidiaries, subject to a recapture mechanism? The answer is, in my view, that this alternative measure – the introduction of a recapture mechanism – would have lead to the factual abolishment of the system of group relief as such. After all, in the UK corporate income tax system companies are individually subject to corporation tax. They cannot be taxed for the profits derived by another group company; the profits of a company which has surrendered losses to a group company are taxable at its own level and not at the level of the group company. In other words, the UK system of group relief is not a system of full tax consolidation, but only a mechanism for the transfer of losses. This fundamental choice made by the UK legislature would have been disrespected if the ECJ would have required the UK to tax profits of a foreign subsidiary in the hands of its UK parent company to the extent that cross-border loss relief had taken place. Such an application of the requirement of subsidiarity would have gone too far; it would have disrespected the principle of direct tax sovereignty. These three reasons show that, in my view, the subsidiarity test is politically more sensitive. This distinguishes the over- and underinclusiveness test from the subsidiarity test.

An example is an exit tax on a fictitious sale of a certain asset at the moment of emigration of the taxpayer (a tax on the difference between the acquisition price of the asset and its fair market value at the time of emigration). This rule aims at preserving a balanced allocation of taxing rights between the Member States. The court may say here that another, less burdensome, measure is available to achieve the same goal, namely the introduction of a tax assessment which is payable only in the event that the assets of which the unrealized gains should be taxed are alienated.[420]

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416 Gerards 2005, p 52.

417 Jans 2000, p 245, referring to Case C-275/92 *Schindler*, § 32 and § 61-62..

418 Alexy 2002, p 400.

419 Case C-446/03 *Marks & Spencer*.

420 See for this idea Case C-436/00 *X&Y*, § 49 (reference is made to the French language version, as the English version erroneously does not state the important second sentence of that paragraph).

7.8 Proportionality stricto sensu

After having established that a measure has a respectful objective in the light of the principle which is *prima facie* infringed, that it has an adequate degree of fit and that it is both a suitable and subsidiary means to achieve this objective, the last step is to look at the result of this exercise and to assess whether ultimately a fair balance is struck between the competing interests (section 4.5.5). In case of normative classifications, a full abstract assessment can be carried out. It should be examined whether the legislator has *in abstracto* weighed the various interests against each other in a reasonable manner. If this abstract assessment leads to the conclusion that the classification is acceptable in itself, one should examine whether the application of the normative regulation *in concreto* takes sufficient account of the individual interests of the party whose *prima facie* right was affected. It should be examined whether a reasonable balance is struck between those interests and the other interests involved. In particular, it should be assessed how important a full application of the legislative act is in the concrete case at hand.[421]

The greater the degree of non-satisfaction of, or detriment to, one principle, the greater must be the importance of satisfying the other. In order to give some more precise meaning to the concept, Alexy has proposed a three-stage scale distinguishing between minor, moderate and serious infringements of a principle on the one hand, and very important, moderately important and relatively unimportant gains on the other (section 4.5.5). These classifications may serve to give a quick solution in relatively easy cases of, for example, a serious infringement of principle A versus a relatively unimportant gain to another principle at the other end: the infringement is disproportionate. In the case of a 'draw' – the principles involved are equally important – the decision-maker enjoys 'structural discretion'. The court will in these situations have to respect the choices which have been made by the legislature, just as it would have to respect the mirror situation in which the legislature would have given preference to the competing principle.

AG Poiares Maduro has confirmed in an opinion in a free movement of goods case that the principle of proportionality indeed consists of three sub-tests (suitability, necessity and balance). The third sub-test, to which the AG refers as 'proportionality *stricto sensu*', is expressed by the AG as the following rule: "the greater the degree of detriment to the principle of free movement of goods, the greater must be the importance of satisfying the public interest on which the Member State relies." Thus, "the Member State must demonstrate that the level of protection it decides to afford to its legitimate interests is commensurate with the degree of interference this causes in intra-Community trade." According to the AG, the difference from the other sub-tests is that, as a result of the third test, "a Member State may be required to adopt a measure that is less restrictive of intra-Community trade, *even if this would lead to a lower level of protection of its legitimate interests*."[422]

[421] Gerards 2005, p 56.

[422] Opinion AG Poiares Maduro in case C-434/04 Ahokainen en Leppik, § 26. Italics by the AG. See for further references to proportionality *stricto sensu* Jans *et al.* 2007, p 158-160. Compare also Mathisen 2010, p 1023 and p 1046-1047.

These considerations mean for direct taxation and free movement cases that it should be examined whether the cost to free movement caused by the tax measure *in abstracto* is *in proportion* to the objectives pursued by it. The individual burden *in concreto* caused by the tax measure should not be disproportionate in view of the aims pursued.[423]

Tax measures which lead to a certain disadvantage (see section 7.3) imply a minor, moderate or serious infringement of the principle of free movement. The principle of direct tax sovereignty cannot fall out of step with that if the tax measure should be upheld. The case of *Marks & Spencer*, discussed in section 2.4 of this study, provides an example. This case concerned the UK system of group relief that allows UK resident companies in a group to offset their profits and losses amongst themselves. This is not allowed for losses incurred by a group company established in another Member State which does not conduct any trading activities in the United Kingdom. The most important objective of the refusal of cross-border group relief is to safeguard a balanced allocation of taxing rights (inter-nation equity). Although the objective of this refusal is respectful, not overinclusive, suitable and subsidiary, the ECJ regarded it as disproportionate not to recognize a cross-border transfer of losses in a particular, exceptional situation which arose in that case, namely where the non-resident subsidiary had exhausted all possibilities of utilizing its losses and the losses could not be taken into account in the future either. In those circumstances, in the words of AG Kokott, the interest in safeguarding the allocation of powers to impose taxes was outweighed by freedom of establishment, and the transfer of losses to the non-resident parent company had to be allowed.[424] The burden on free movement was apparently so great on Alexy's above-mentioned three-stage scale that it could not outweigh the interests of the internal market – equal tax treatment of parent companies with domestic and foreign subsidiaries – in a situation of a final loss which cannot be used locally.

Another example is the imposition of a general non-discriminatory marginal tax rate of 95%. Let us assume that the taxpayer claims that he suffers a disadvantage which consists of the difference between this tax rate and a rate which can be regarded as reasonable in the light of the free movement provisions (a tax rate which is as high as 95% renders the principle of free movement almost illusionary). If this tax rate does not have the objective of prohibiting economic activities but is, for instance, solely related to the objective of redistribution of income, it is not in itself disrespectful towards free movement. The measure will also meet the requirements of a sufficient degree of fit, suitability and subsidiarity. The requirement of proportionality in the narrow sense is however capable of striking a balance between the competence to redistribute income and the need of free movement in the internal market. The ECJ would in such a case be competent to decide that this particular tax is a disproportionate infringement of free movement.[425] It would

[423] See the Opinion of AG Kokott in case C-319/02 Manninen, § 49, where the AG expressly mentions the need to apply proportionality analysis in the narrow sense of the term to tax measures.

[424] Opinion in Case C-231/05 *Oy AA*.

[425] It is interesting to note in this respect that the ECJ held in Case C-47/88 Commission v Denmark, § 12, that "it is not permissible for the Member States to impose on products which, in the absence of comparable domestic production, escape the application of the prohibitions contained in [Article 110 TFEU] charges of such an amount that the free movement of goods

subsequently be for the national court to decide how the tax rate should be adjusted, in line with the constitutional rules of that Member State (a court may not be able to introduce a tax rate which the legislature has not adopted).[426]

7.9 Conclusion

This chapter has shown that Alexy's theory of principles provides a useful assessment model to optimize the principles of national direct tax sovereignty and free movement, thereby respecting the idea that both principles should be neutral towards each other in their objectives (twofold neutrality). This model is external to and independent of the ECJ's current case law. As such it is able to serve as an objective framework which can be used to assess whether the ECJ's case law in the area of direct taxation and free movement strikes a fair balance between the competing principles or not. Thus far, the model makes a normative claim. The following theoretical assessment model has been proposed:[427]

1. To which *disadvantage* does the tax measure lead?
2. Does the tax measure at issue have a *respectful aim*?
3. If yes, is the tax measure *suitable* to achieve its aim?
4. If yes, does the tax measure have a sufficient *degree of fit* in relation to its aim?
5. If yes, does the tax measure reflect the most *subsidiary* means to achieve its aim?
6. If yes, is the cost to free movement caused by the tax measure *in proportion* to the aims pursued by it?

Disadvantage identification is necessary because a court should be able to verify the *petitum* or claim of the taxpayer: which amount of tax should be refunded in case the court found in favour of the taxpayer? In the event of legislative classifications on grounds of cross-border movement of the legal form of an establishment, it is clear that the disadvantage lies in the difference with the domestic situation and the other legal form. In respect of direct tax measures which do not make a distinction on grounds of cross-border activity, it depends on the type of the rule how the 'disadvantage' is identified (section 7.3.2). In respect of anti-abuse rules, for example, the disadvantage would consist of the difference between the tax due without these rules and the tax due after application of these rules. In respect of taxation *as such*, the disadvantage would consist of the difference between the tax due and no taxation at all. Clearly, such a claim would generally not be sustained, because this would mean that the principle of free movement would not respect the principle of tax sovereignty as its limit; such a claim denies the very existence of a State's tax sovereignty. Section 7.4.2 has considered the possibility of introducing a 'but for' test in phase 1 of the model as a result of the above-mentioned observations: a restriction of

within the common market would be impeded as far as those goods were concerned.". In Case C-383/01 De Danske Bilimportører, § 40, the ECJ reiterated this consideration.

426 See on this issue Douma 2008a with further references.

427 As stated in section 7.3, J.H. Gerards has developed a model for the principle of equality which serves as an inspiration for the assessment model presented here. This is particularly true for the test of 'disadvantage'. See Gerards 2005, chapter 2, and in particular p 76-79 and p 99-102.

free movement would exist whenever the activity concerned would have been taxed under a less burdensome tax rule BUT FOR the tax measure considered. The 'but for' test would make it possible to calculate the tax due *without the measure at issue* in a meaningful way. In addition, it would acknowledge that taxation *as such* should not be regarded as a restriction of free movement. Although a 'but for' test would be a useful tool for identifying disadvantages in (corporate) income tax systems, it was finally decided not to include a 'but for' test in the model for two reasons. First, a 'but for' test would filter out in the first phase of the model tax rules which make the exercise of the principle of free movement almost impossible (e.g. extremely high tax rates), where these rules should be able to be examined for their proportionality in the narrow meaning of the term. Second, the 'but for' test has already been used in the area of State aid law in the EU and the WTO, but not entirely without difficulty. In order not to get lost in this discussion, section 7.4.2 concluded that it would be better not to include a 'but for' test in the first phase of the model, but rather to apply the model as a whole to every tax rule which causes an identifiable 'disadvantage'. It should be noted in this respect that disadvantages due to disparities in the tax systems of Member States are outside the scope of the theoretical optimization model altogether, because in these cases there is no conflict between the principles of direct tax sovereignty and free movement.

The second phase of the assessment model requires that the objective of a tax measure which leads to a disadvantage is respectful towards the principle of free movement (section 7.4). *Vice versa*, the principle of free movement should respect the principle of direct tax sovereignty. This idea of a 'twofold neutrality' means that direct tax measures should have an objective which is unrelated to the effect of the measure (i.e. an unequal tax treatment of domestic and cross-border situations or a general limitation on economic liberty). If a certain measure does not have a stated credible objective, it should be assumed that its objective coincides with its effects. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. This means that taxation *as such* is not disrespectful towards the principle of free movement. This also means that the absence of rules for the avoidance of international juridical double taxation is not disrespectful. Although there is no conceptual difference in the analysis of rules with internal and external objectives respectively, it is useful to distinguish between the two for illustration purposes. Tax measures with an 'internal' aim which lead to a certain disadvantage are not respectful towards free movement if the reason for that disadvantage is of a budgetary nature (the principle of direct tax sovereignty cannot determine its own extent). The same is true for anti-abuse measures which apply solely because a taxpayer has established itself in another Member State with a low effective tax rate; to this extent, proportionality analysis cannot be applied. The *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction can, however, serve as a limit to free movement. Tax measures with an 'external' aim which lead to a certain disadvantage have two specific features in comparison with rules which have an internal objective. In the first place, 'internal' grounds of inter-nation equity or the *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction may not be able to serve as a credible reason for the alleged disadvantage. In

the second place, external objectives may more easily than internal objectives run against the requirement that they also have to abide by other requirements than free movement which the TEU and the TFEU contain.

The third phase of the assessment model concerns the test of 'suitability'. Once it has been ascertained that a measure which causes an identified disadvantage has a respectful objective and has a sufficient degree of fit, it should be assessed, factually, whether the measures is apt to attain its objective (section 7.5).

The fourth phase of the model examines the degree of fit or the over- and/or underinclusiveness of a classification (section 7.6). Overinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too widely. Underinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too narrowly. It is important that the formulation of each classification matches as closely as possible the intended goal, because it should be avoided that persons unjustifiably fail to receive certain benefits or are unjustly burdened or disadvantaged. Tax measures which are, for instance, targeted at influencing the behaviour of individual taxpayers lead to a specific interference with the principle of free movement. This makes it possible to conduct a very specific examination of the degree of fit. For instance, with regard to measures of general tax policy aimed at achieving taxpayer equity, the Member State should have a wide margin of discretion. After all, the principle of free movement cannot impose a concept of its own of reasonable and correct law-making (e.g. the principle of free movement cannot prescribe where tax brackets should begin or end in an income tax system with progressive tax rates).

The test of subsidiarity requires that of two broadly equally suitable means, the one which interferes less intensively with the affected principle should be chosen (section 7.7). The requirement of subsidiarity does not address the way in which the classification is defined, but relates to the choice of the classification as a means of achieving the intended goal. The subsidiarity test examines whether it was actually necessary to make a distinction, aside from the question as to how this distinction is actually defined. Thus, the test of subsidiarity does not take the classification of the contested measure as a given, but requires that the court more or less independently investigates the available alternatives which are equally suitable to achieve the objective pursued. This politically more sensitive task distinguishes the over- and underinclusiveness test from the subsidiarity test.

The sixth and last phase of the assessment model concerns the test of proportionality in the narrow sense (proportionality *stricto sensu*; section 7.8). It requires that the disadvantages caused by the measure should not be not disproportionate to the aims pursued (a balance test). The greater the burden on the fundamental freedoms, the stronger the countervailing objective should be.

Part III

Optimization by the ECJ in Direct Taxation Cases

8. Optimization by the European Court of Justice in direct tax cases: assessment of current practice and future developments

8.1 Introduction

Part II has been devoted to the clash between national tax sovereignty and the requirements of the provisions of free movement in the TFEU. A theoretical optimization model has been submitted which should serve to optimize the principle of direct tax sovereignty and the principle of free movement. Part III of this study analyzes the ECJ's case law in the light of this model. It will examine three things. First, it will be discussed how the ECJ decides tax cases at present. Second, it will be reviewed how this practice fits into the theoretical optimization model. To the extent that this practice does not fit into the model, an attempt will be made to provide an explanation for that. Third, to the extent that ECJ case law is insufficient to draw conclusions regarding the ECJ's stance on the model in direct taxation cases in certain situations, a proposal will be made on how the ECJ should decide these situations. Since there are already over 150 ECJ judgments in the area of direct taxation, not all of the case law can be discussed; not all 150 judgments can be confronted with the theoretical optimization model in extenso. I have, therefore, selected the judgments with the highest profile in tax literature, either because they reflect a particularly doctrinal stance of the ECJ or because they are regarded as controversial. The selection discussed hereafter provides, in my view, a good illustration of how the ECJ operates in direct taxation cases in the respective phases of the theoretical optimization model. The selection will discuss i) case law which is in line with the theoretical optimization model, ii) controversial case law which is nevertheless in line with the model and iii) case law which is not in line with the model. It will not be discussed whether the cases in question are 'right' or 'wrong' if they are compared to each other, because that is not the purpose of the present part of this study: the purpose is to examine to what extent current ECJ case law fits into the theoretical optimization model and what future developments should be expected on a more general level.[428] I have decided to discuss the selected ECJ judgments in the phase of the model where they are the most relevant or interesting. In my view, this approach is the most reader-friendly way of presenting the findings of the present study; it would be a rather dull exercise to take 150 ECJ judgments all the way through the model.

[428] As explained in section 7.1, the present study does not claim that the theoretical optimization model at necessitates only one solution in an individual case.

One may object that this approach does not show to what extent the selected judgments indeed essentially follow the approach presented in the model or can be structured by the model. I would not agree to such an objection, because the elements of the ECJ judgments discussed in the various phases of the model reflect the most controversial parts of the judgment; elements which are far more easy to place in the model need not be discussed separately. The table in the appendix to this study shows which direct taxation cases would have been decided differently under the approach followed in the model.

8.2 Disadvantage identification or the scope of the principle of free movement in direct taxation cases

8.2.1 Current ECJ case law on direct taxation

8.2.1.1 Introductory remarks

In *Säger*, the ECJ held that the free movement provisions require not only the elimination of all discrimination on grounds of nationality but also the abolition of any restriction when it is liable to prohibit or otherwise impede economic activities.[429] Thus, a national measure which is liable to prohibit or otherwise impede economic activities restricts free movement *even in cases where there is no allegation of discrimination on grounds of nationality*.[430] Following this definition, the ECJ has, in its general non-tax case law, acknowledged three types of restrictions of free movement. First, there are national rules of a Member State regulating the pursuit of (economic) activities which are such as to place cross-border activity in conditions of *law* or of *fact* that are worse than those of domestic activity. Second, there are national rules of a Member State which directly affect *access* to the market by reason of their objective or effects.[431] This approach focuses on the more general question of whether a national measure is liable to prohibit or otherwise impede access to the market or exercise of free movement. Third, Articles 49 and 54 TFEU guarantee that a company has the right to choose freely the legal form of a secondary establishment in another Member State: a subsidiary or a permanent establishment. A differential treatment of those legal forms may constitute a restriction of the freedom of establishment.

In its case law on direct taxation, the ECJ has in practice applied the first type of restriction on free movement, although there are possibly a few exceptions.[432] The third type of restriction has also been recognized,[433] even in cases where a different treatment on the basis of the legal form of an establishment did not coincide with a disadvantageous

[429] Case C-76/90 *Säger*, § 12. See also Case C-19/92 *Kraus*; Case C-55/94 *Gebhard*, § 37, Case C-298/05 *Columbus Container Services*, § 34, and the case law cited there.

[430] Case C-169/07 *Hartlauer Handelsgesellschaft*, § 33, and the Opinion of AG Sharpston in case Case C-96/08 *CIBA*, § 39.

[431] Opinion AG Tizzano in Case C-442/02 *CaixaBank France*, § 76.

[432] Possible exceptions include Case C-433/04 *Commission v. Belgium* and Case C-293/06 *Deutsche Shell*.

[433] Case C-307/97, *Compagnie de Saint-Gobain*; Case 270/83, *Commission v. France (Avoir fiscal)*; Joined Cases C-439/07 et C-499/07 *KBC Bank*, § 76-80.

treatment of cross-border activity.[434] Apart from this case law, according to the majority of scholars, a direct tax measure only constitutes a restriction on free movement if it treats a cross-border activity worse than a domestic activity: a discrimination approach.[435] A direct tax measure which does not lead to a disadvantage, either in law or in fact, for cross-border investment would in this view not constitute a restriction on free movement (see section 2.2.4 of the present study). In his opinion in *Test Claimants in Class IV of the ACT Group Litigation,* AG Geelhoed noted that the ECJ frequently uses the language of 'discrimination' instead of non-discriminatory 'restrictions' in the context of the free movement provisions applied to direct taxation measures. The ECJ has consistently held these provisions to prohibit discrimination, both direct discrimination (i.e. measures differentiating overtly on nationality grounds) and indirect or 'covert' discrimination (i.e. measures equally applicable in law but with a discriminatory effect in fact). In this regard, the ECJ has defined the concept of discrimination as the 'application of different rules to comparable situations' or 'the application of the same rule to different situations'. The question of whether two cases are in an objectively comparable situation must be answered in light of the object and purpose of the measure under consideration.[436] It is AG Geelhoed's view "that, in the direct taxation sphere, there is no practical difference between these two manners of formulation i.e. 'restriction' and 'discrimination'."[437] AG Geelhoed stated his view even more clearly in his opinion in *Test Claimants in the Thin Cap Group Litigation*:

> "the concept of indistinctly applicable 'restrictions' of freedom of movement used in the Court's general free movement case-law cannot meaningfully be transposed *per se* to the direct tax sphere. Rather, due to the fact that criteria for asserting tax jurisdiction are generally nationality- or residence-based, the question is whether the national direct tax measure is indirectly or directly discriminatory".[438]

Also according to Wattel, the application of the approach of "non-discriminatory restrictions" does not seem to make much sense in direct tax cases.[439] The question of whether this view is actually correct will be discussed below in 8.2.1.5. First, we will review the easier cases of disparity, double taxation and discrimination.

8.2.1.2 Disparities

General remarks

As stated in section 2.2.4, a consequence of the co-existence of discrete national tax systems is that disparities, or variations, exist between these jurisdictions.[440] For example, a Member

[434] Case C-253/03, *CLT-UFA SA*, echoed in Case C-231/05 *Oy AA*, § 40.
[435] Kingston 2007a, p 309, and Snell 2007, p 349 *et seq.*
[436] Case C-418/07 *Société Papillon*, § 27. This approach is also apparent in Case C-231/05 *Oy AA*, § 38.
[437] Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, § 35-36.
[438] Opinion AG Geelhoed in Case C-524/04 *Thin Cap Group Litigation*, § 48.
[439] Terra & Wattel 2008, p 344.
[440] Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation,* § 43.

State may choose to impose a relatively high tax rate within its jurisdiction. The existence of these disparities has inevitable distorting effects on investment, employment and, for companies and self-employed persons, establishment decisions. Possible distortions resulting from mere disparities between tax systems do not, however, fall within the scope of the EU free movement provisions in the TFEU.[441] The ECJ has consistently held:

> "that, in prohibiting every Member State from applying its law differently on the ground of nationality, within the field of application of the Treaty, Articles [18, 49 and 56 TFEU] are not concerned with any disparities in treatment which may result, between Member States, from differences existing between the laws of the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality."[442]

Accordingly, it is clear that the obstacles resulting from disparities may be contrasted with obstacles resulting from discrimination which occurs as a result of the rules of just one tax jurisdiction.[443] Discrimination and disparity are two concepts which are mutually exclusive. In a discrimination analysis, both the situations to be compared should be wholly or partially located within the same jurisdiction. In cases of disparity, one of the comparable situations is wholly outside the jurisdiction of the State which is being accused of discrimination. It is important to note that the ECJ has accepted that Member States enter into tax treaties to allocate between themselves direct tax jurisdiction to avoid double taxation. If an allocation of jurisdiction to one of the Member States results in, for instance, a higher tax rate than that which would have applied in respect of an allocation of jurisdiction to the other Member State, the resulting disadvantage is the outcome of a disparity and is not a discrimination.[444] Similarly, a disadvantage not resulting from a change of jurisdiction by a certain tax treaty *rule* but by a change of *facts* – for example emigration to another Member State – does not constitute a discrimination but is the consequence of a disparity. As the ECJ has held in *Lindfors*:

> "[EU law] offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstance. It follows that, in principle, any disadvantage, by comparison with the situation in which that citizen carried on activities prior to that transfer, is not contrary to [Article 21 TFEU], provided that the legislation concerned does not place that citizen at a disadvantage as compared with those already subject to such a tax (…)."[445]

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441 Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation,* § 46. See also Case C-403/03 *Schempp,* § 45.

442 Case 1/78 *Kenny*, § 18; Case C-177/94 *Perfili.*

443 See Douma 2006, p 524-526.

444 Case C-336/96 *Gilly*.

445 Case C-365/02 *Lindfors*, § 34. See also Case C-387/01 (*Weigel*), § 55. See, in relation to social security, Joined Cases C-393/99 and C-394/99 *Hervein and Others,* § 51.

In *Lütticke* the ECJ held that Article 110 TFEU regards "the legal relationships between the Member States and *persons within their jurisdiction*."[446] This is also true in the area of State aid:

> "30. Under [Article 107(1) TFEU] 'any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in as far as it affects trade between Member States, be incompatible with the common market'.
> 31. This provision thus refers to the Decisions of Member States by which the latter, in pursuit of their own economic and social objectives, give, by *unilateral and autonomous* Decisions, undertakings or other persons resources or procure for them advantages intended to encourage the attainment of the economic or social objectives sought."[447]

This is logical, because an advantage or a disadvantage for a taxpayer should be attributable to a Member State under the EU free movement provisions, State aid rules or the general EU principle of equality. Otherwise, it would be blamed for something out of its competence. *Porto Antico di Genova* concerned the Italian tax on the income of legal persons (IRPEG) and the Italian regional tax on production (IRAP). These taxes included grants paid by the Community Structural Funds in the assessment of taxable income. The taxpayer argued, *inter alia*, that the differences which existed between the beneficiaries of the Structural Funds, by reason of the different rates of taxation imposed in the Member States on amounts received by way of Community assistance, should be considered as being liable to breach the principle of equal treatment, which precludes comparable situations from being treated in a different manner unless the difference in treatment is objectively justified. The ECJ rejected this argument:

> "For that to be the position, it would be necessary for the situations of the beneficiaries of Community aid to be comparable. That cannot be the case since those beneficiaries receive that aid in a socio-economic context specific to each Member State and, in the absence of Community harmonisation on the assessment of taxable income, objective disparities between the rules in Member States still exist in that field, thereby inevitably creating such differences between those beneficiaries."[448]

Again, disadvantages as a result of the fact that other rules apply in other tax jurisdictions are outside the scope of the principle of equality. In the same vein, Barnard has argued that, "once an individual has been admitted to the *territory* of a Member State he or she cannot be discriminated against on the grounds of nationality in respect of access to, or exercise of, a particular trade or profession."[449]

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446 Case 57/65 *Lütticke*.
447 Case 61/79 *Denkavit italiana*.
448 Case C−427/05 *Porto Antico di Genova*, § 20.
449 Barnard 2010, p 237.

The reason why obstacles resulting from disparities are not a discrimination or discriminatory restriction is probably that the TFEU cannot compel a Member State to tax persons within its jurisdiction under the rules of another Member State. For example, a Netherlands resident company cannot argue that it should be taxed at a lower corporate income tax rate on the ground that a company resident in Estonia is subject to this low rate. After all, the Netherlands does not have the legislative jurisdiction to amend the Estonian tax rate to the Netherlands level. In other words, a taxpayer's claim for the extension of a rule to its own situation is outside the scope of the EU free movement provisions if the claim relates to the extension of a rule that was not adopted by the legislator of the Member State involved. In respect of disparity in direct tax systems, the free movement provisions cannot be applied.

An illustrative example of a disparity under the Dutch principle of equality is provided by a judgment of the Dutch Council of State (acting in its capacity of Supreme Administrative Court). A flower shop in the Amsterdam district of *Bos en Lommer* could not set up flower stall on the pavement due to a regulation of the district council. A competing flower shop on the other side of the street, however, was allowed to do so because it was located in another district (*De Baarsjes*); the district frontier runs exactly over the middle of the road. The flower shop argued that the advantageous treatment of its direct competitor infringed the principle of equality. The Council of State, however, decided that decisions of *De Baarsjes* cannot constitute obligations *vis-à-vis Bos en Lommer*.[450] The parallel with direct taxation in the European Union is evident.

Now I will give three examples from the ECJ's case law in the field of direct taxation in which discrimination could not be established because the disadvantageous treatment was the result of a disparity in national tax legislation.

Gilly

Mr. and Mrs. Gilly resided in France, near the German border. Mr. Gilly, a French national, taught at a State school in France. Mrs. Gilly, who was a German national also with French nationality by marriage, taught at a State primary school in Germany in the frontier area. With regard to the taxation of employment income, Art. 14(1) of the France-Germany tax treaty states that taxpayers receiving remuneration and pensions from the public sector are, in principle, taxable in the paying State if the taxpayer has the nationality of that State (this was the case because Mrs. Gilly also had German nationality). In respect of double taxation, the tax treaty effectively provides for an exemption in France of the positive income that is, under the tax treaty, taxable in Germany. This exemption is achieved by granting to a French resident a tax credit that corresponds to the French income tax attributable to the income taxable in Germany. Consequently, the tax credit to be set off against the French tax may be less than the tax paid in Germany, as the tax scale in Germany is more progressive. French frontier workers taxed both, in Germany, on income received there and, in France, on their total income after deduction of this tax credit may, therefore, be taxed more heavily than persons receiving exactly the same income but only in France. Mr. and Mrs. Gilly argued that the application of these provisions of the tax treaty resulted in unjustified, discriminatory and excessive taxation that was incompatible

[450] ABRvS 26 September 1996, AB 1996/483.

with the free movement of workers (Article 45 TFEU), because the higher tax burden would not have occurred if Mrs. Gilly had not had German nationality. In effect, Mr. and Mrs. Gilly contended that France should make good the increase of their tax burden, which was caused by the allocation of taxing power to Germany, by paying the difference between the German and French level of taxation. In so doing, Mrs. Gilly would effectively be taxed according to the French rules, notwithstanding the fact that Germany had the jurisdiction to tax.

The ECJ stated that, whilst the abolition of double taxation within the Community is one of the objectives of the EC Treaty,[451] it must, however, be noted that no unifying or harmonizing measure for the elimination of double taxation had been adopted at Community level nor had the Member States concluded any multilateral convention to this effect under Article 293 EC.[452] Accordingly, the Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation, by way, *inter alia*, of international agreements, and have concluded many tax treaties based, in particular, on the OECD Model Tax Convention. It is, therefore, clear that the various provisions of the tax treaty set out different connecting factors to allocate jurisdiction.

The ECJ observed that this differentiation cannot be regarded as discrimination prohibited under the fundamental freedoms, even if the criterion of nationality is used for the purpose of the allocation of fiscal jurisdiction.[453] Whether or not the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor, but by the level of taxation in the competent Member State, in the absence of any EU harmonization of scales of direct taxation.[454] Double taxation could only be fully avoided by a tax credit equal to the tax charged in Germany. The ECJ also observed that any unfavourable consequences in *Gilly* entailed by the tax credit mechanism were the result of the differences between the tax rates of the Member States concerned and, in the absence of any EU legislation in the relevant area, the Member States determined these rates.[455] In addition, if the Member State of residence had to grant a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income. This would entail a loss of tax revenue for the Member State and would encroach on its sovereignty in matters of direct taxation.[456]

As stated previously, Mrs. Gilly's claim would effectively have resulted in taxation according to the French rules, notwithstanding the fact that Germany had jurisdiction to tax. The reason why the ECJ decided that Mrs. Gilly was not discriminated against with regard to a person taxable in France was that France did not have the legislative jurisdiction to adjust the German tax rate to the French level. If Germany had applied a tax rate that was similar to the French tax rate, the differential treatment between French

451 Note that Article 293 EC has been repealed in the TFEU.
452 Case C-336/96 *Gilly*, § 23.
453 Case C-336/96 *Gilly*, § 30.
454 Case C-336/96 *Gilly*, § 34.
455 Case C-336/96 *Gilly*, § 47.
456 Case C-336/96 *Gilly*, § 48.

frontier workers taxable in Germany and persons receiving exactly the same income but only in France would disappear. Accordingly, the difference was the result of a disparity.

Schempp

Mr. Schempp, a resident of Germany, paid maintenance to his former spouse resident in Austria. The deductibility in Germany of maintenance payments by a resident taxpayer to a recipient resident in another Member State was conditional on their being taxed in that other Member State. Because Mr. Schempp's former spouse was not taxed in Austria on the maintenance payments, Mr. Schempp could not apply for a deduction in Germany. Had she been resident in Germany or another Member State which does tax maintenance payments, the deduction would have been granted. Mr. Schempp argued that this differential treatment infringes Article 21 TFEU (freedom to travel and reside freely in the European Union).

The ECJ held first that the situation at issue falls within the scope of EU law. This decision was important because Mr. Schempp had not exercised his right to freedom of movement. His former spouse, however, had exercised the right granted by Article 21 TFEU to every citizen of the Union to move and reside freely in the territory of another Member State. Since the exercise by Mr. Schempp's former spouse of a right conferred by the EU legal order had an effect on his right to deduct in his Member State of residence, such a situation cannot be regarded as an internal situation with no connection with EU law. The ECJ therefore went on to examine whether Articles 18 TFEU and 21 TFEU preclude the German tax authorities from refusing deduction of the maintenance paid by Mr. Schempp to his former spouse resident in Austria.[457]

In that regard, the ECJ found it apparent that the unfavourable treatment of which Mr. Schempp complains in fact derives from the circumstance that the tax system applicable to maintenance payments in his former spouse's Member State of residence differs from that applied in his own Member State of residence. The ECJ then reiterated that it is settled case-law that Article 21 TFEU is not concerned with any disparities in treatment, for persons and undertakings subject to the jurisdiction of the Union, which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality. It followed that the payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient resident in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system. Consequently, the fact that a taxpayer resident in Germany is not able to deduct maintenance paid to his former spouse resident in Austria does not constitute discrimination within the meaning of Article 18 TFEU.[458]

The differential treatment according to the place of residence of the recipient was, therefore, the result of a disparity in tax legislation. As a consequence, the principle of equality could not be applied. The German rule was, in itself, completely neutral. At the same time, EU law does not guarantee that the transfer of residence of Mr. Schempp's former spouse will be neutral as regards taxation. Given the disparities in the tax legislation

[457] Case C-403/03 *Schempp*, § 22-26.
[458] Case C-403/03 *Schempp*, § 32-36.

of the Member States, such a transfer may be to Mr. Schempp's advantage in terms of taxation or not, according to circumstance.[459]

Cassis de Dijon

As stated in the introduction to this section, all national rules of a Member State regulating the pursuit of (economic) activities which are such as to place cross-border activity in conditions of *law* or of *fact* that are worse than those of domestic activity constitute a restriction on free movement. Such discrimination can arise through the application of different rules to comparable situations or the application of the same rule to different situations.[460] The category of application of the same rule to different situations is often applied by the ECJ in situations where a State takes insufficient account of the fact that a good of person coming from another Member State has also been regulated in the State of origin. The ECJ has developed the principle of mutual recognition for these situations. The principle of mutual recognition means that products and services lawfully produced and put on the market in Member State A can and should be allowed access to the market of Member State B, which can only restrict free movement on the basis of overriding reasons in the general interest. Or, in the words of the ECJ in *Cassis*, the sale of products "lawfully produced and marketed in one of the Member States (…) may not be subject to a legal prohibition on the marketing" of those products. However, "[o]bstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer."[461] Rules justified on any of these or other grounds should also respect the principle of proportionality.[462] As Barnard has explained, indistinctly applicable measures like the ones in *Cassis* apply in law to both national and domestic products but in fact have a particular burden on important goods. She explains that this "different burden may arise because, while the national producer has to satisfy only one regulator (the home State) the imported goods have to satisfy a dual regulatory burden (home State and host State regulation)". This is a more covert type of discrimination.[463] This idea has also been applied to the free movement of persons and services. Requirements as to holding particular qualifications of licences are also considered to be indirectly discriminatory. The discrimination arises "because the requirements create a double burden on migrants who have to satisfy two sets of rules (those of the home and host States) while nationals only have to satisfy one set of rules (those of the home State)."[464] Thus, the obstacles arising from disparities in situations like *Cassis* are fundamentally different from cases like *Gilly* and *Schempp*, because in *Cassis* the rules of one Member State were at stake which *in fact* discriminated against cross-

459 Compare Case C-365/02 *Lindfors*, § 34.

460 Case C-279/93 (*Schumacker*), § 30; Case 13/63 *Commission v. Italy (Italian refrigerators)*, § 4(a).

461 Case 120/78 *Cassis de Dijon*, § 8.

462 Case 261/81 *Rau*, § 12.

463 Barnard 2010, p 90-91.

464 Barnard 2010, p 239-240.

border activity. In *Gilly* and *Schempp*, however, the Member States concerned did not discriminate *within their own jurisdiction*. Therefore, these cases have to be distinguished from *Cassis*.

8.2.1.3 International juridical double taxation

In section 2.2.4 of the present study it has been explained that *international juridical double taxation* does not imply discriminatory treatment by a single Member State.[465] The disadvantage a taxpayer suffers in case of an overlap of direct tax jurisdictions is not attributable to unilateral unequal treatment in one single jurisdiction. As a result, international juridical double taxation does not amount to a *prima facie* restriction on free movement.[466] The leading case here is *Kerckhaert and Morres*. Mr. and Mrs. Kerckhaert-Morres, two residents of Belgium, had received dividends from a French company. In Belgium, these dividends were taxable at a rate of 25%. Upon distribution, the dividends had already been subject to a 15% withholding levy in France. As a result, the dividends were taxed twice, because Belgium – under its tax treaty with France – did not provide any relief for the avoidance of double taxation. Mr. and Mrs. Kerckhaert-Morres argued that the Belgian tax violated EU free movement of capital (Article 63 TFEU), as cross-border dividends were taxed twice, whereas an internal dividend would have been taxed only once. Following AG Geelhoed,[467] the ECJ decided that international juridical double taxation is not contrary to the EU rules on free movement. First, it stated that the Belgian tax legislation does not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State. Under Belgian law both are taxed at an identical rate of 25% by way of income tax.[468] Second, the ECJ acknowledged that discrimination may consist not only in the application of different rules to comparable situations but also in the application of the same rule to different situations. However, in respect of the tax legislation of his State of residence, the position of a shareholder receiving dividends is not necessarily altered, in terms of that case-law, merely by the fact that he receives those dividends from a company established in another Member State, which, in exercising its fiscal sovereignty, makes those dividends subject to a deduction at source by way of income tax.[469] According to the ECJ, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue do not result from any discrimination but from the exercise in parallel by two Member States of their fiscal sovereignty.[470] This does not amount to a restriction on free movement, which is a clear statement of principle.[471]

The judgment in *Kerckhaert* is in line with the case law on Article 110 TFEU, where double taxation has been accepted. The case of *Larsen and Kjerulff* concerned a

[465] See Raingeard de la Blétière 2011, p 71.
[466] Case C-513/04 *Kerckhaert and Morres*; Case C-298/05 *Columbus Container Services*; Case C-194/06 *Orange European Smallcap Fund*; Case C-67/08 *Block*.
[467] See § 27-36 of his Opinion. See also Wattel 2003, p 199.
[468] Case C-513/04 *Kerckhaert and Morres,* § 17.
[469] Case C-513/04 *Kerckhaert and Morres,* § 19.
[470] Case C-513/04 *Kerckhaert and Morres,* § 20.
[471] Snell 2007, p 360.

dispute between the Danish national authority for the control of precious metals and two goldsmiths over the payment of a charge introduced to cover the expenses of the supervision of undertakings manufacturing, importing or dealing in articles of precious metal. The question arose as to whether the charge was discriminatory if the products in question were intended to undergo a fresh control, with the levying of charges in respect thereof, in the country of destination. The ECJ held:

> "33. (…) that the EEC Treaty contains no provision prohibiting effects of double taxation of this type.
> 34. Although the abolition of such effects is doubtless desirable in the interests of the freedom of movement of goods, it can however only result from the harmonization of the national systems (…).
> 35. At present, Community law does not however contain any rules which prevent a Member State from also including, in the application of a system of taxation intended to finance the control of precious metal, products intended for export.
> 36. For the same reason, the fact that a system of taxation is arranged so that the same quantity of metal marketed on the national territory can be included only once for the purpose of establishing the basis of assessment to the levy intended to finance the control of precious metal is not such as to make the application of the same tax to exported products appear discriminatory when the procedures for the control and for the taxation of imports in other states are not within the influence of the exporting state."[472]

A similar decision was handed down in *Nygård*.[473] Mr. Nygård, a pig breeder established in Denmark, exported to Germany live pigs intended for abattoirs. With regard to this, he paid a production levy in Germany for each pig supplied to the abattoirs. He refused to pay another production fee in Denmark, payable for each pig slaughtered there or exported live, concerning the same pigs.[474] Mr. Nygård argued primarily that the levy imposed on live pigs for export was a charge having an equivalent effect of a customs duty on exports within the meaning of Articles 28 and 30 TFEU. The Danish failure to take into consideration the fiscal situation on the actual slaughter of the pigs in the country of importation gave rise to double taxation in respect of exported pigs. The ECJ, however, stressed that the fact that the pigs exported live subsequently incur a levy when they were supplied for slaughter in the country of importation had no bearing on the classification of the Danish system of taxation.[475] According to the ECJ, EU law, as it stands at present, does not contain any provision to prohibit the effects of double taxation in the case of charges, such as those in the case in question, that are governed by independent national legislation. In addition, whilst the elimination of such effects is desirable in the interests

[472] Case 142/77 *Larsen and Kjerulff*.
[473] Case C-234/99 *Nygård*.
[474] Case C-234/99 *Nygård*, § 6. A production levy is charged in Denmark for every pig bred and slaughtered in Denmark and declared fit for human consumption following inspections carried out by the public authorities. This levy is also charged for every pig bred in Denmark and exported live.
[475] Case C-234/99 *Nygård*, § 37.

of the free movement of goods, it may nevertheless only result from the harmonization of national systems.[476]

The case of *Scharbatke* concerned the mirror image of *Larsen and Kjerulff* and *Nygård* since it concerned a charge imposed by the importing country. The ECJ held:

> "14. In its second question, the national court also asks whether a parafiscal charge of that kind at issue in the main proceedings constitutes internal taxation prohibited by [Article 90 EC] when a similar charge which has already been levied on the same products in the exporting State has not been taken into account.
> 15. It must be observed in that regard that although under the system of value added tax (VAT) and on the basis of the harmonization rules in this field the VAT paid in the exporting Member State must be taken into account, as stated in the judgment in Case 15/81 Schul v Inspecteur der Invoerrechten en Accijnzen [1982] ECR 1409, that solution cannot be applied to charges regulated by independent national legislation, such as those at issue in the main proceedings.
> 16. (…) The mere fact that the charge is levied on imported products without deduction of a domestic charge, similar in kind but regulated independently by national legislation which was imposed on the same products in the exporting Member State, does not render the charge incompatible with [Article 90 EC]."[477]

This case law is consistent with the judgment in *Kerckhaert and Morres*. Section 8.2.2.3 will discuss whether this case law is consistent with the theoretical optimization model.

8.2.1.4 Discrimination

Introduction
Any direct tax rule which makes – in law or in fact – a *distinction on grounds of the nationality of the taxpayer* or on grounds of *cross-border (economic) activity* amounts to a *prima facie* restriction on free movement. Section 2.2.4 has mentioned some examples to illustrate this. Here a selection thereof will be elaborated a little further. The cases have been selected on their ability to illustrate how the ECJ deals with jurisdictional arguments in the first phase of assessment.[478]

Discrimination on grounds of residence: person-related income[479]
In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable as regards the need to take into account their ability to pay.[480] The ECJ recognizes the difference between the limited fiscal jurisdiction of the source Member State and the unlimited fiscal jurisdiction of the residence Member State. It noted that international tax law – in particular the OECD Model Tax Convention – recognizes that

[476] Case C-234/99 *Nygård*, § 38.
[477] Case C-72/92 *Scharbatke*.
[478] See Cordewener 2002, p 888 et seq, for an elaborate discussion.
[479] See Van der Vegt & Douma 2005, § 4.2.
[480] Case C-279/93 *Schumacker*, § 31.

in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence.[481] The position is, however, different if the non-resident receives no significant income in the Member State of residence and obtains most of his taxable income from an activity performed in the Member State of source, with the result that the Member State of residence cannot grant the benefits resulting from taking into account his personal and family circumstances.[482] In such a case, there is no objective difference between the situations of such a non-resident and a resident engaged in comparable activities to justify different treatment regarding the taking into account for taxation purposes of the taxpayer's personal and family circumstances.[483] As a consequence, in short, the *Schumacker* doctrine states that the Member State of residence must ensure the effective application of its tax rules on personal and family circumstances, unless the taxpayer obtains his income entirely or almost exclusively from the work performed in the Member State of source.[484] In the latter case, the Member State of source must take the personal and family circumstances of the taxpayer into account.[485]

Discrimination on grounds of residence: source-related income[486]

Residents and non-residents are however, as a rule, comparable regarding the consideration of costs that are directly linked to a source of income within the jurisdiction of the source Member State. Mr. *Gerritse*, for example, was a tax resident of the Netherlands. He performed for a short period as a drummer in Germany. Gerritse's claim for a deduction of business expenses in Germany was rejected by the German tax authorities. The ECJ noted that the business expenses in question were directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents were in a comparable situation in this respect.[487] There are a number of further judgments in which the ECJ has recognized the effect of the limited fiscal jurisdiction of the source Member State. *Futura Participations SA*, a company with its seat in Paris, had a Luxembourg branch, Singer. Futura sought to set off, for Luxembourg corporate income tax purposes, 'French' losses incurred by the head office against the profits of the Luxembourg branch. Under Luxembourg law, the losses must be economically linked to the income in Luxembourg, so that only losses arising from Futura's activities in Luxembourg could be considered. According to the ECJ, "such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination" prohibited by EU law.[488]

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481 Case C-279/93 *Schumacker*, § 32.

482 Case C-279/93 *Schumacker*, § 36.

483 Case C-279/93 *Schumacker*, § 37.

484 This doctrine was further elaborated on in, inter alia, Case C-391/97 *Gschwind*; Case C-87/99, *Zurstrassen*; Case C-169/03 *Wallentin*; Case C-329/05 *Meindl*.

485 If the Member State of source has taken the personal and family circumstances of the taxpayer into account, the Member State of residence is not required to do the same. See Case C-385/00 *De Groot*.

486 See for a discussion Monsenego 2011, p 306 et seq.

487 Case C-234/01 *Gerritse*, § 27. See also Case C-265/04 *Bouanich*, § 40; Case C-346/04 *Conijn*, § 20-24; Case C-440/08 *Gielen* (an option for treatment as a resident taxpayer cannot remedy the original discrimination as regards these expenses); Case C-450/09 *Schröder*.

488 Case C-250/95 *Futura Participations SA and Singer*, § 22.

This was further explained in *Royal Bank of Scotland* where the ECJ recognized the effect of the limited fiscal jurisdiction of the source Member State. Specifically, the ECJ observed that resident companies are taxed on the basis of their world-wide income (unlimited tax liability), whereas foreign companies carrying on business in that State through a permanent establishment are subject to tax there only on the basis of profits which the permanent establishment earns there (limited tax liability). This circumstance, which arises from the limited fiscal sovereignty of the source State, is not such as to prevent the two categories of companies from being considered, all other things being equal, as being in a comparable situation as regards the method of determining the taxable base.[489]

The message is clear. Equal treatment should be guaranteed within the boundaries of the limited fiscal jurisdiction of the source Member State. This reveals that this Member State should, in any case, provide equal treatment to taxpayers, insofar as their activities are within its jurisdiction as determined by customary international law and tax treaties. If so, the taxpayers concerned find themselves in comparable situations for purposes of the discrimination analysis. This is not only true with regard to internal rules that distinguish between residents and non-residents,[490] but also for rules enshrined in a tax treaty that make this distinction. An illustrative example of the last situation is *Saint-Gobain*. Briefly, Germany's tax treaties with the United States and Switzerland provided for a participation exemption in Germany with regard to dividends paid by a resident of the United States or Switzerland to a resident of Germany. Saint-Gobain, a company resident in France, had a permanent establishment (PE) in Germany. The profits of the PE included dividends from the United States and Switzerland. The ECJ held that the participation exemption should apply to the dividends, as a company resident in Germany receiving the same dividends would also benefit from the participation exemption. As Saint-Gobain and a company resident in Germany were both to the same extent in the tax jurisdiction of Germany with regard to the dividends, they were in comparable situations. The ECJ stated that the Member States are free, within the framework of bilateral agreements concluded to prevent double taxation, to determine the connecting factors for the purposes of *allocating* powers of taxation as between themselves. As far as the *exercise* of the power of taxation so allocated is concerned, however, the Member States may not disregard EU law.[491]

As appears from the *D* case, however, the fact that the situations to be compared are both within the same jurisdiction does not guarantee the equal treatment of those situations. Mr. D resided in Germany. On 1 January 1998, 10% of his wealth consisted of real property situated in the Netherlands, whilst the remainder was held in Germany. He was liable to Netherlands wealth tax, as a non-resident taxpayer. Taxpayers resident in the Netherlands were entitled to an allowance applied to their net worldwide assets, whilst non-resident taxpayers taxed on their net assets in the Netherlands were not entitled to an allowance. Although he did not hold 90% of his wealth in the Netherlands – as a consequence he did

[489] Case C-311/97 *Royal Bank of Scotland*, §29. This has been confirmed in Case C-345/04, *Centro Equestre*, § 22-25 and Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, § 68. Compare also Case C-284/06 *Burda*, § 87 et seq, and Case C-182/08 *Glaxo Wellcome*, § 69 *et seq*.

[490] See, for example, Case 270/83 *Commission v. France* (*Avoir fiscal)*.

[491] Case C-307/97 *Compagnie de Saint-Gobain*, § 57. See also the insightful article by Gammie 2005, p 271-272.

not meet the requirements of the *Schumacker*-doctrine, discussed above – Mr. D applied, on the basis of EU law, for this allowance. *Inter alia*, he argued discrimination in respect of Article 63 TFEU and the 1970 Belgium-Netherlands tax treaty, under which residents of Belgium, who owned the same property in the Netherlands, were entitled to the allowance. Mr. D stated that the allowance should also be granted to residents of Germany, as both situations were to the same extent located within the jurisdiction of the Netherlands. The ECJ, however, considered that the fact that the reciprocal rights and obligations of the Belgium-Netherlands tax treaty applied only to persons resident in these Member States was an inherent consequence of tax treaties. Consequently, the ECJ held that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as wealth tax on real property situated in the Netherlands is concerned.[492]

Discrimination on grounds of residence: the peculiar cases of Lakebrink and Renneberg

The above-described clear distinction between person-related items of income (which are outside the source State's tax jurisdiction) and source-related items of income (which are inside the source State's tax jurisdiction if they are directly linked to source State income) has become blurred in two later cases.[493] In *Lakebrink*, the ECJ extended the *Schumacker*-doctrine to any tax advantages connected with the non-resident's ability to pay tax which are not taken into account either in the State of residence or in the State of employment "since the ability to pay tax may indeed be regarded as forming part of the personal situation of the non-resident within the meaning of the judgment in *Schumacker*."[494] In *Renneberg*, the ECJ even went a step further. Mr. Renneberg lived in Belgium and worked in the Netherlands with the municipality of Maastricht. His dwelling in Belgium was financed with a loan on which he paid interest. This interest could not be deducted in the Netherlands because the 1970 Belgium-Netherlands tax treaty allocated both positive and negative income from that dwelling exclusively to Belgium. The ECJ applied the *Schumacker*-doctrine to the negative income (i.e. the interest payments), notwithstanding the fact that this income was outside the source State's (the Netherlands') tax jurisdiction.[495] A person who derives most of his taxable income from salaried employment in another Member State and has

[492] Case 376/03, *D. v. Inspecteur*, § 61.

[493] It should be noted that the ECJ noted already in Case C-80/94 *Wielockx*, § 19, that "the situations of residents and of non-residents in a given State are not generally comparable, since there are objective differences between them from the point of view of the source of the income and the possibility of taking account of their ability to pay tax *or* their personal and family circumstances".

[494] Case C-182/06 *Lakebrink*, § 34. Note that Case C-152/03 *Ritter* concerned a situation where Germany, under the particular facts of that case, took into account positive income from a private dwelling in another Member State for purposes of determining the tax rate, whereas it excluded negative income for these purposes. The ECJ held that this contravened free movement of workers. *Ritter* should be distinguished from *Lakebrink*: in the first case the Schumacker-doctrine was not relevant because Germany took positive income into account under its national legislation, whereas Luxembourg did not do that in the latter case. Compare also Case C-35/08 *Busley and Cibrian* for an example of a case where foreign losses could only be offset against positive income from similar foreign sources: this runs contrary to the principle of free movement.

[495] Case C-527/06 *Renneberg*, § 66-68.

no significant income in his Member State of residence is, for the purposes of taking into account his ability to pay tax, in a situation objectively comparable, with regard to his Member State of employment, to that of a resident of that Member State who is also in salaried employment there. Therefore, Article 39 EC (free movement of workers; Article 45 TFEU) required the Netherlands to take Renneberg's negative income into account for the purposes of determining the basis of assessment of taxable income. In summary, after *Lakebrink* and *Renneberg*, source-related items of income which are not directly linked to income in the source State do not have to be taken into account by the source State, unless the taxpayer derives most of his taxable income in the source State and has no significant income in his Member State of residence.

Equal treatment in the Member State of origin: jurisdictional arguments not per se accepted
It has been discussed in section 2.2.4 of the present study that any direct tax measure which makes a distinction on grounds of cross-border (economic) activity constitutes a *prima facie* restriction on free movement. The fact that the economic activity, or a part thereof, takes place outside a Member State's tax jurisdiction is not relevant in this regard. This does not make the cross-border situation incomparable to the domestic situation. In *Marks & Spencer*, the ECJ accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognized by EU law. However, the fact that an EU Member State "does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not *in itself* justify restricting group relief to losses incurred by resident companies." Therefore, jurisdictional arguments are not *by themselves* capable of making a domestic and a cross-border situation incomparable.[496] For instance, a Member State cannot refuse on the basis of the principle of territoriality that a domestic parent company deducts interest payments in relation to the acquisition of a foreign subsidiary, where such a deduction is possible in relation to a domestic subsidiary.[497] Moreover, the free movement provisions not only prohibit a disadvantageous treatment of cross-border economic activity vis-à-vis domestic economic activity, but also a unilateral disadvantageous treatment of one cross-border economic activity vis-à-vis another cross-border economic activity.[498]

Equal treatment in the Member State of origin: the cases of Cadbury Schweppes, FII and Columbus Container Services
Three cases concerning equal treatment in the Member State of origin require special attention, because they seem to be contradicting each other – this will be discussed in section 8.2.2.5.

[496] Case C-446/03 *Marks & Spencer*, § 39-40. Compare also Case C−414/06 *Lidl Belgium*, § 23-26, and Case C-337/08 *X Holding*, § 19.
[497] Case C-168/01 *Bosal Holding BV*.
[498] Case C-196/04 *Cadbury Schweppes*, § 45; Case C-194/06 *Orange European Smallcap Fund NV*, § 56. Case C-436/08 *Haribo*, § 48, seems to exclude this comparison in third country situations.

The case of *Cadbury Schweppes* concerned the UK rules on the taxation of controlled foreign companies. This legislation is designed to apply when the CFC is subject, in the State in which it is established, to a 'lower level of taxation', which is the case, under that legislation, in respect of any accounting period in which the tax paid by the CFC is less than three quarters of the amount of tax which would have been paid in the United Kingdom on the taxable profits as they would have been calculated for the purposes of taxation in that Member State. The taxation provided for by the legislation on CFCs is excluded when 'the motive test' is satisfied. The latter involves two cumulative conditions. First, where the transactions which gave rise to the profits of the CFC produce a reduction in United Kingdom tax compared to that which would have been paid in the absence of those transactions and where the amount of that reduction exceeds a certain threshold, the resident company must show that such a reduction was not the main purpose, or one of the main purposes, of those transactions. Secondly, the resident company must show that it was not the main reason, or one of the main reasons, for the CFC's existence to achieve a reduction in United Kingdom tax by means of the diversion of profits. According to that legislation, there is a diversion of profits if it is reasonable to suppose that, had the CFC or any related company established outside the United Kingdom not existed, the receipts would have been received by, and been taxable in the hands of, a United Kingdom resident.[499] Clearly, the CFC legislation is designed in such a way that the profits of a non-resident subsidiary of a UK parent company remain taxable in the UK in situations which the UK legislature regards as abusive. In respect of the question of whether the CFC legislation constitutes a *prima facie* restriction on freedom of establishment, the ECJ observed that the CFC legislation does not apply in situations involving domestic subsidiaries or foreign subsidiaries which are resident in a Member State with a level of taxation which is not 'lower'. Both comparisons imply a restriction on freedom of establishment.[500]

The case of *FII* concerned the former UK imputation system regarding the taxation of dividend distributions. The ECJ held – in the context of the UK system – that an exemption of domestic dividends and an indirect tax credit in relation to foreign dividends did not infringe the EU free movement provisions, on the condition that the aim of the system – i.e. the avoidance of economic double taxation – is equally met in both situations.[501] According to the ECJ, "the mere fact that, compared with an exemption system, an imputation system imposes additional administrative burdens on taxpayers, with evidence being required as to the amount of tax actually paid in the State in which the company making the distribution is resident, cannot be regarded as a difference in treatment which is contrary to freedom of establishment, since particular administrative burdens imposed on resident companies receiving foreign-sourced dividends are an intrinsic part of the operation of a tax credit system." This is true only if the exemption for domestic dividends essentially has the same result as an imputation system would have had. It was for the national court to determine whether this was indeed the case.

499 Case C-196/04 *Cadbury Schweppes*, § 7-11.

500 Case C-196/04 *Cadbury Schweppes*, § 43-46. Compare also AG Léger's Opinion in that case at § 78.

501 Case C-446/04 *Test Claimants in the FII Group Litigation*, § 49-57.

The case of *Columbus Container Services* concerned the German rules regarding the switch-over from the exemption method for permanent establishment profits to the credit method in the event that the establishment in another Member State was, *inter alia*, subject to a low tax rate and performed 'passive' activities.[502] These rules essentially reflect the application of CFC legislation to permanent establishments: the profits of a company or a permanent establishment are not exempted but taxed – with a tax credit for foreign corporation tax – in situations deemed to be abusive (erosion of the national tax base by relocating activities to another State solely for tax reasons). Contrary to its decision in Case C-196/04 *Cadbury Schweppes* – which concerned the application of similar rules to foreign subsidiaries – the ECJ decided that the German rules did not constitute a *prima facie* restriction on freedom of establishment. First, the ECJ stated that the switch-over to the credit method does not result in a higher tax burden in comparison with a domestic activity: in both situations the same amount of German income tax is payable (§ 40). Second, the ECJ held that the fact that the switch-over to the credit method only applies to permanent establishments in Member States with a low tax rate and not to similar activities in other Member States does not amount to a *prima facie* restriction on freedom of establishment. According to the ECJ, the adverse consequences which might arise from the application of the switch-over method result from the exercise in parallel by two Member States of their fiscal sovereignty (§ 43, referring to *Kerckhaert and Morres*, discussed in section 8.2.1.3). With respect to the switch-over method's distortion of the choice that companies and partnerships have to establish themselves in different Member States, the ECJ replied: "in the current state of harmonisation of Community tax law, Member States enjoy a certain autonomy. It follows from that tax competence that the freedom of companies and partnerships to choose, for the purposes of establishment, between different Member States in no way means that the latter are obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to guarantee that a company or partnership that has chosen to establish itself in a given Member State is taxed, at national level, in the same way as a company or partnership that has chosen to establish itself in another Member State" (§ 51). This incomprehensible paragraph means that Germany is free to apply the exemption method for PE profits in respect of one Member State and the credit method in respect of another Member State, even in the absence of abusive behaviour of the taxpayer, which was after all the objective of the switch-over method.

In summary, the ECJ regarded a disadvantageous treatment in comparison with i) a domestic situation and ii) another cross-border situation as *prima facie* discriminatory in *Cadbury Schweppes*, whereas it did not see any discrimination with respect to the first comparison in *FII* and did not see any discrimination with respect to the first comparison in *Columbus*. The question of whether these different results can be explained by the theoretical optimization model will be discussed in section 8.2.2.5.

Measures for the avoidance of international juridical double taxation

We have seen in section 8.2.1.3 that international juridical double taxation does not as such amount to a restriction on free movement. As soon as a Member State has designed

[502] Case C-298/05 *Columbus Container Services*.

rules for the avoidance of such double taxation, however, it seems possible to test these rules for compatibility with the EU free movement provisions.

The case of *De Groot* is the first example.[503] This case concerned Mr. De Groot, a Netherlands national and resident, who had employment in various Member States. De Groot was obliged to make maintenance payments to his former wife. Under Dutch rules for the avoidance of international juridical double taxation, De Groot's income from foreign employment was exempt. This exemption was calculated by first deducting a proportional part of the maintenance payments from the gross income, which resulted in a lower exemption. As a result, a proportional part of these payments was allocated to the source States. The ECJ held that De Groot suffered a real disadvantage as a result of the application of the proportionality factor since he derived from his maintenance payments a lesser tax advantage than he would have received had he received his entire income for 1994 in the Netherlands (§ 83). This disadvantage is attributable neither to the disparities between the tax systems of the Member States of residence and employment nor to the tax systems of the various States in which Mr. De Groot was employed (§ 85): it arises as a result of the application of a Dutch rule in the Dutch tax jurisdiction (§ 93-94). Moreover, it is a matter for the State of residence, in principle, to grant the taxpayer all the tax allowances relating to his personal and family circumstances because that State is best placed to assess the taxpayer's personal ability to pay tax, since that is where his personal and financial interests are centred (§ 90). International tax law, and in particular the OECD Model Tax Convention, recognizes that, in principle, the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence (§ 98). For these reasons, the Dutch proportionality factor constituted a *prima facie* restriction on free movement of workers. In the following justification analysis, the ECJ noted that the Member States are of course free, in the absence of unifying or harmonizing measures adopted in the Union, to alter, by way of bilateral or multilateral agreements for the avoidance of double taxation, the correlation between the total income of residents and residents' general personal and family circumstances to be taken into account by the State of residence. The State of residence can therefore be released by way of an international agreement from its obligation to take into account in full the personal and family situation of taxpayers residing in its territory who work partially abroad. The State of residence may also be released from that obligation if it finds that, even in the absence of a convention, one or more of the States of employment, with respect to the income taxed by them, grant advantages based on the personal and family circumstances of taxpayers who do not reside in the territory of those States but receive taxable income there (§ 99-100). However, the mechanisms used to eliminate double taxation or the national tax systems which have the effect of eliminating or alleviating double taxation must permit the taxpayers in the States concerned to be certain that, as the end result, all their personal and family circumstances will be duly taken into account, irrespective of how those Member States have allocated that obligation amongst themselves, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws (§ 101).

[503] Case C-385/00 *De Groot*.

The cases of *AMID* and *Mertens* are a second example of scrutiny by the ECJ of rules for the avoidance of international juridical double taxation, which did not allow for the carry-over of positive foreign source income in situations where the foreign income is positive and the domestic income is negative, as a result of which no effective exemption can be given in that year.[504] The case of *AMID* concerned the Belgian exemption method for the avoidance of double taxation of income from a foreign permanent establishment. The Belgian rules allowed a company established in Belgium to deduct a loss incurred in a previous year from the taxable profit for the current year only on the condition that that loss was not capable of being set off against the profit made during that same previous year by one of its permanent establishments situated in another Member State. The ECJ held that Article 49 TFEU precludes such legislation since the loss, although set off, in that case against the profit made by one of AMID's permanent establishments in Luxembourg, could not be deducted from taxable income in either of the Member States concerned, whereas it would have been deductible if the establishments of that company had been situated exclusively in the Member State in which the company had its seat. The case of *Mertens* concerned a computer consultant resident in Belgium. He was at the same time employed in Germany and self-employed in Belgium. For the 1989 tax year, his self-employed business in Belgium suffered a loss. In his tax return for the following year, Mr. Mertens mentioned the loss that he had incurred in the previous tax year and sought to deduct it from the profit generated by his self-employed business in Belgium. However, when he received his assessment of personal tax for the tax year 1990, he found that the loss carried over had not been taken into account by the Belgian tax authorities, because this loss had already been set off against the positive German employment income in the previous year and the German income could not be carried over to the next year. The ECJ took the opportunity in *Mertens* to clarify its position in *AMID*. The ECJ admitted that the Belgian legislation applies without distinction to all taxpayers who have suffered losses in respect of a self-employed activity, given that business losses incurred during a taxable period in respect of any business activity or employment are always to be deducted from income from other activities, including, therefore, remuneration received in respect of employment in Belgium (§ 30). However, taxpayers who, like Mr. Mertens, exercise their right to freedom of movement and are simultaneously self-employed in Belgium and employed in another Member State, are – in the light of the applicable bilateral tax treaties – not in a position comparable to that of taxpayers who carry on all their occupational activities exclusively in Belgium. Under tax treaties, income from employment is normally taxable in the State of employment, whereas business income is taxable in the State where the business is situated (the loss incurred in Belgium could not be taken into account in Germany; § 31). Thus, there is a fundamental jurisdictional difference between both categories. By treating these incomparable situations in the same way, the Belgian rules amounted to a *prima facie* restriction on free movement of workers: the Belgian rules are likely to dissuade a taxpayer who is in the position of Mertens from entering into or continuing with employment in another Member State (§ 32-33). Finally, the ECJ noted that the disadvantage suffered by Mertens is the direct result of the application of the Belgian legislation and not of an inevitable disparity between the Belgian and German tax legislation (§ 36).

[504] Case C-141/99 *Amid*; Case C-431/01 *Mertens*.

The third example is the case of *Seabrokers*, which resembles the approach in *AMID* and *Mertens*.[505] Seabrokers is a Norwegian company which operates a real estate business in Norway through a parent company and five subsidiaries there. It develops and rents out its properties, all of which are regulated as offices/industry. The properties are – or are in the process of becoming – developed with office buildings financed by loans guaranteed by mortgages on the properties. Seabrokers also has a branch in Aberdeen in the United Kingdom (the UK), whose only business activity is ship broking. Renting its office space, the branch has no investment in real property, with the exception of a detached house purchased for the use of employees. Since its only debts are due to operating expenses, the branch has low debt interest costs. Having registered it as a branch of a foreign enterprise in the UK, Seabrokers has submitted tax declarations for the branch's operations in the UK and has been charged tax on its operations there. Under Norwegian rules for the avoidance of international juridical double taxation, debt interest expenses and group contributions were apportioned to the income from the UK permanent establishment in accordance with the principle of net income taxation. This apportionment results in a lower credit allowance in Norway, because it decreases the foreign income. The question arose of whether it is contrary to the EEA Agreement's freedom of establishment (Article 31 EEA) to attribute, in accordance with the principle of net income taxation, debt interest and group contributions to the income abroad when calculating the maximum credit allowance. With respect to interest expenses, the EFTA Court recalled that the EEA Agreement does not oblige the Member States to give relief for double taxation within the European Economic Area, nor does it lay down any criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation. Consequently, the Member States have retained their competence to determine the connecting factors for the *allocation* of their fiscal jurisdiction, *inter alia* by concluding bilateral agreements. However, as far as the *exercise* of their taxation power so allocated is concerned, the EEA States must comply with EEA rules (§ 48). Thus, it needs to be assessed whether rules limiting maximum credit allowance restrict the freedom of establishment under Article 31 EEA (§ 49). The difference between Seabrokers' actual tax burden in Norway and the UK and the tax burden which it would have borne had all its operations been conducted in Norway, caused by the difference in tax rates under the two respective tax regimes (28% and 30%), does not constitute a restriction on the freedom of establishment. However, differences caused by the method of avoiding double taxation by Norway – assuming that the Norwegian and UK tax systems are otherwise equal – may amount to a restriction. In order to determine whether such a disadvantage is the mere result of the application in parallel of two different tax systems, or a restriction on the freedom of establishment that falls under Article 31 EEA, it needs to be assessed whether a company with a branch in another EEA State is in a situation which is, with regard to those expenses, objectively comparable to that of a company having all its business within the home State (§ 52). The EFTA Court decided that such comparability should be decided on the basis of jurisdictional principles (§ 54). Interest expenses which are directly attributable to income taxable in the UK may in this approach decrease the maximum credit allowance. The same applies to interest expenses which are directly attributable to

[505] Case E-7/07 *Seabrokers*.

neither UK nor Norwegian income: these expenses may be attributed *pro rata parte* to UK income (§ 55). However, a company conducting all its business in its home State and having all its debt interest expenses linked to that State, and a company conducting its business in its home State and through a branch in another EEA State (the host State) but having all its debt interest expenses linked to the home State, are in a comparable situation with respect to these expenses. Thus, they should get the same tax treatment in the home State with respect to these expenses (§ 56). The same is true for deductible group contributions between Seabrokers and one of its Norwegian group companies: they cannot in any way be attributed to the UK tax jurisdiction. In this light, attributing group contributions in circumstances such as in the case at hand to the income of a branch situated in another EEA State does not correspond to the situation of the taxpayer. Therefore, the EFTA Court concluded that it constitutes a restriction within the meaning of Article 31 EEA to attribute group contributions to the income of a branch situated in another EEA State when calculating the maximum credit allowance (§ 68).

A fourth example is the case of *Krankenheim Ruhesitz am Wannsee*.[506] This case concerned a German company which had a permanent establishment in Austria from 1982 to 1994. Before the end of 1990, it made losses at that establishment. Those losses were taken into account in Germany for German corporate income tax purposes. Between 1991 and 1994, at its permanent establishment in Austria, KR Wannsee made profits. In 1994, KR Wannsee disposed of that permanent establishment. In accordance with the provisions of German tax law then in force, the profits made by the permanent establishment in Austria during the period 1991 to 1994 were added to the total income obtained by KR Wannsee in Germany (claw-back mechanism). Germany thus retrospectively taxed the sums previously deducted in the context of national taxation, in respect of the losses incurred by the permanent establishment in Austria. In Austria, KR Wannsee was charged corporation tax in 1992 and 1993, during which business years its permanent establishment made profits. On that occasion, the losses previously incurred by that company in the said establishment were not taken into account. The ECJ observed that Germany had granted a tax advantage to KR Wannsee by allowing foreign permanent establishment losses as a deduction, in the same way as if that permanent establishment had been situated in Germany. However, by subsequently proceeding to reintegrate losses by the said permanent establishment into the basis of assessment of the head office when the latter had made profits, the German tax system withdrew the benefit of that tax advantage. According to the ECJ, even though that reintegration operated only up to the amount of the profits made by that permanent establishment, the fact remains that, to that extent, the German legislation thus subjected resident companies with permanent establishments in Austria to less favourable treatment than that enjoyed by resident companies with permanent establishments situated in Germany. In those circumstances, the tax situation of a company which has its registered office in Germany and has a permanent establishment in Austria would be less favourable than it would be if the latter were to be established in Germany (§ 37). As a consequence, the claw-back mechanism constitutes a *prima facie* restriction on freedom of establishment. Turning to justification analysis, however, the ECJ held that this restriction was justified by the need

[506] Case C−157/07 *Krankenheim Ruhesitz am Wannsee.*

to guarantee the coherence of the German tax system. The reintegration of losses cannot be dissociated from their having earlier been taken into account. That reintegration, in the case of a company with a permanent establishment in another State in relation to which that company's State of residence has no power of taxation, as the referring court indicates, reflects a logical symmetry. When performing proportionality analysis, the ECJ observed that the restriction is appropriate to achieve the objective of coherence in that it operates in a perfectly symmetrical manner, only deducted losses being reintegrated. Moreover, that restriction is entirely proportionate to the objective pursued, since the reintegrated losses are reintegrated only up to the amount of the profits made (§ 44-45). The fact that KR Wannsee could not carry forward its losses in Austria to future taxable years, as a result of which it was taxed twice on its permanent establishment profits in 1991-1994, does not mean that the claw-back mechanism is disproportionate. Even supposing that the combined effect of taxation in the State where the head office of the permanent establishment concerned is situated and tax due in the State where that establishment is situated might lead to a restriction of the freedom of establishment, such a restriction is imputable only to the latter of those States. In such a case, that restriction would arise not from the tax system at issue in the main proceedings, but from the allocation of tax competences under the German-Austrian tax treaty (§ 51-52).

A fifth example is the case of *Orange European Smallcap Fund*.[507] This case concerned the Dutch special corporate income tax regime for portfolio investment funds. This regime provides for (1) taxation of the fund at a rate of 0% and (2) a credit of dividend withholding tax (DWT) to the fund with regard to dividends received by the fund. It is aimed at providing equal treatment of direct portfolio investments on the one hand and indirect portfolio investments – through an intermediary investment fund – on the other. In 1997, Orange European Smallcap Fund NV (OESF) - whose shareholders resided in various (EU and non-EU) countries – had received dividends from various countries, including Portugal and Germany. These dividends had been subject to foreign DWT. OESF claimed a (substitute) credit for those foreign withholding taxes. This credit was, pursuant to Dutch legislation, restricted in two ways. Firstly, no credit of DWT was granted with regard to the dividends from Portugal and Germany, because of the non-existence (in 1997) of tax treaties between the Netherlands and those countries providing for a right to a credit of foreign DWT against Dutch income tax. Secondly, with regard to the dividends from other foreign countries, the credit of DWT was reduced in proportion to the participation in OESF by shareholders not residing in the Netherlands. OESF claimed a full credit for all foreign DWT. With respect to the just-mentioned first criterion, the ECJ held that the exclusion from the DWT credit of dividend from Member States without a tax treaty with the Netherlands makes investment in those Member States less appealing than investment in the Member States in which the taxation at source of those dividends gives rise to that credit. Such legislation is therefore liable to deter a collective investment enterprise from investing in the Member States in which the taxation of dividends does not give rise to the concession and accordingly constitutes a *prima facie* restriction on the free movement of capital (§ 56). This restriction was however justified by the nature of the Dutch tax regime at issue. By granting the DWT credit, the Netherlands legislation at issue seeks to

[507] Case C-194/06 *Orange European Smallcap Fund NV*.

make dividends received by a shareholder investing directly subject as far as possible to the same treatment for tax purposes as those received by a shareholder investing through the intermediary of a fiscal investment enterprise, so as to prevent investments abroad by such an enterprise from being regarded as less appealing than direct investments. However, under such legislation, where a fiscal investment enterprise receives dividends from Member States with which the Netherlands has concluded a tax treaty providing for shareholders who are natural persons to be entitled to credit the tax which those Member States have deducted from the dividends to the income tax for which those shareholders are liable in the Netherlands, the situation of that enterprise is different from that in which it finds itself when receiving dividends from Member States with which the Netherlands has not concluded such a convention, as there is no such entitlement in respect of those dividends (§ 61). The conclusion must be that it does not run counter to the free movement provisions to restrict measures for the avoidance of international juridical double taxation in respect of resident taxpayers in tax treaties to situations falling within the scope of that particular tax treaty.[508]

A sixth example concerns the above-discussed case of *Columbus Container Services* – the description of this case is repeated here.[509] This case concerned the German rules regarding the switch-over from the exemption method for permanent establishment profits to the credit method in the event that the establishment in another Member State was, *inter alia*, subject to a low tax rate and performed 'passive' activities. These rules essentially reflect the application of CFC-legislation to permanent establishments: the profits of a company or a permanent establishment are not exempted but taxed – with a tax credit for foreign corporation tax – in situations deemed to be abusive (erosion of the national tax base by relocating activities to another State solely for tax reasons). The ECJ decided that the German rules did not constitute a *prima facie* restriction on freedom of establishment. First, the ECJ stated that the switch-over to the credit method does not result in a higher tax burden in comparison with a domestic activity: in both situations the same amount of German income tax is payable (§ 40). Second, the ECJ held that the fact that the switch-over to the credit method only applies to permanent establishments in Member States with a low tax rate and not to similar activities in other Member States does not amount to a *prima facie* restriction on freedom of establishment. According to the ECJ, the adverse consequences which might arise from the application of the switch-over method result from the exercise in parallel by two Member States of their fiscal sovereignty. With respect to the switch-over method's distortion of the choice that companies and partnerships have to establish themselves in different Member States, the ECJ replied: "in the current state of harmonisation of Community tax law, Member States enjoy a certain autonomy. It follows from that tax competence that the freedom of companies and partnerships to choose, for

[508] Compare however the above-discussed Case C-307/97 *Compagnie de Saint-Gobain*, where the ECJ held that such measures should not discriminate against non-resident taxpayers receiving income from the same Member State as an otherwise comparable resident taxpayer. Compare also the above-discussed Case 376/03 *D. v. Inspecteur*, where the ECJ decided that tax treaty advantages may be restricted to non-resident taxpayers who are a resident of the other Contracting State and do not have to be extended to taxpayers resident in other EU Member States even if those taxpayers receive exactly the same income from the Netherlands.

[509] Case C-298/05 *Columbus Container Services*.

the purposes of establishment, between different Member States in no way means that the latter are obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to guarantee that a company or partnership that has chosen to establish itself in a given Member State is taxed, at national level, in the same way as a company or partnership that has chosen to establish itself in another Member State" (§ 51).

A last example is the case of *Haribo and Österreichische Salinen*. In this case, no effective tax credit for a foreign withholding tax on dividends was available for the purpose of avoidance of international juridical double taxation, because the recipient of the dividends was in a loss position in the tax year concerned. The question arose whether the absence of a carry-forward of the non-credited foreign withholding tax to a subsequent tax year is contrary to free movement of capital. The ECJ answered this question negatively. It reiterated that the disadvantages which may arise from the parallel exercise of powers of taxation by different States, in so far as such an exercise is not discriminatory, do not constitute restrictions prohibited by the Treaty. Accordingly, Article 63 TFEU cannot be interpreted as obliging a Member State to provide, in its tax legislation, that a credit is to be granted for the withholding tax levied on dividends in another Member State or third country in order to prevent the international juridical double taxation.[510]

Exit taxation

The position that jurisdictional arguments are not, by definition, decisive was confirmed by the ECJ judgment in the *N*-case.[511] This case concerned the Dutch taxation of latent increases in value of shares, the taxable event being the transfer of the residence of a taxpayer, with a 'substantial holding' in a company, outside the Netherlands. It was possible to benefit from suspension of payment until the disposal of the shares, subject to conditions, such as the provision of guarantees. In addition, decreases in value occurring after the transfer of residence were not taken into account in order to reduce the tax debt. The ECJ considered that this 'exit tax' at issue is in itself a *prima facie* restriction on free movement which can be justified by the need to maintain a balanced allocation of taxing powers between the Member States. Nevertheless, in order to be regarded as proportionate to the objective pursued, such a system for recovering tax on the income from securities would have to take full account of reductions in value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State.

Discrimination on grounds of legal form

In the case of *Saint-Gobain,* the ECJ held that the second sentence of the first paragraph of Article 49 TFEU expressly confers on economic operators "the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State".[512] Likewise, in the case concerning *Avoir fiscal* the ECJ considered that traders are free to choose the appropriate legal form in which to pursue their activities in another Member State and

510 Joined Cases C−436/08 and C−437/08 *Haribo and Österreichische Salinen*.
511 Case C-470/04 *N*.
512 Case C-307/97 *Saint-Gobain*, § 42.

that this freedom of choice must not be limited by discriminatory tax provisions.[513] Both in *Saint-Gobain* and in *Avoir fiscal* the discrimination regarding free choice of legal form was inextricably bound up with discrimination as to the choice of place of residence, because a disadvantageous treatment of a branch vis-à-vis a subsidiary implies a disadvantageous treatment of a non-resident company vis-à-vis a resident company. In the judgment in the case of *CLT-UFA,* the criterion of free choice of legal form was however applied separately (in respect of the host State). A remark by the ECJ in *Oy AA* points in the same direction.[514] In respect of the Member State of origin, it is unclear to what extent undertakings may invoke free choice of legal form.[515] The Opinion of AG Poiares Maduro in *Marks & Spencer* seems to answer this question positively.[516] In any event, there is no case law which firmly states that the free choice of legal form can never be invoked in respect of the Member State of origin. The case of *X Holding* is an interesting example.[517] This case concerned the Dutch fiscal unity regime which makes it possible for a parent company to elect its subsidiaries as tax transparent. In case of such an election, the subsidiaries are treated as domestic 'permanent establishments' of the parent company. The purpose of this option is to make it possible that groups of companies – which are economically one undertaking – are taxed as one single entity. X Holding argued that its Belgian subsidiary was comparable to a Belgian permanent establishment of a Dutch company in view of this objective: to make it possible to treat subsidiaries and domestic 'permanent establishments' the same. The ECJ rejected this argument by pointing out that permanent establishments situated in another Member State and non-resident subsidiaries are not in a comparable situation with regard to the allocation of the power of taxation in tax treaties. As a consequence, the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments (§ 40). I do not infer from this judgment that a separate application of the right of free choice of legal form is not possible in respect of the Member State of origin. On the contrary: a difference in treatment always needs justification.

8.2.1.5 Non-discriminatory tax obstacles

Introduction

At present, the vast majority of ECJ case law in the field of direct taxation does not concern situations in which genuinely non-discriminatory tax measures were at issue. As a consequence, the ECJ has not been in the position to decide under which circumstances, if at all, a non-discriminatory tax measure can be tested for compatibility with the free movement provisions.[518] The ECJ has however always left it open whether it is prepared to

[513] Case 270/83 A*voir fiscal*, § 22.

[514] Case C-253/03 *CLT-UFA*; Case C-231/05 *Oy AA*, § 40.

[515] See for a good overview of the case law Joined Cases C-439/07 and C-499/07 *KBC Bank*, § 76-80.

[516] Opinion AG Poiares Maduro in Case 446/03 *Marks & Spencer*, § 42-48.

[517] Case C-337/08 *X Holding*.

[518] It should be noted that disadvantages resulting from non-discriminatory tax measures should be distinguished from disadvantages resulting from disparities: the first type of disadvantage results from the application of tax legislation of a single Memer State wheras the second type

test truly non-discriminatory tax rules which lead to a 'disadvantage'. Although Kingston has suggested that the ECJ is now definitely moving towards a discrimination approach in direct tax cases,[519] I agree with Banks[520] that the language used by the ECJ in these cases continues to use (also) the *Säger* formula involving national rules which are 'liable to prohibit or otherwise impede' economic activities, irrespective of any discrimination.[521] Indeed, although the majority of tax scholars is of the view that a direct tax measure only constitutes a restriction on free movement if it treats a cross-border activity worse than a domestic activity – i.e. a discrimination approach; see the introduction to this section – the question arises whether this is always true,[522] in particular having regard to the fairly recent cases of *Commission v. Belgium*[523] and *Deutsche Shell*.[524] These cases will be discussed after an account has been given of ECJ case law on taxation and non-discriminatory obstacles to free movement.

Viacom Outdoor

The question of whether the concept of non-discriminatory restrictions on free movement can meaningfully be transposed to direct taxation has been addressed explicitly by AG Kokott in *Viacom Outdoor*.[525] This case concerned an Italian rule under which municipalities levy a tax payable on advertising services by means of bill-posting in public spaces. The question arose as to whether freedom to provide services precludes such a municipal advertising tax. AG Kokott noted that freedom to provide services can be restricted in two ways. First, it contains a specific expression of the general principle of non-discrimination. In the present case, however, it is not clear whether the municipal advertising tax could lead to – even only indirect – discrimination against cross-border services. She observed that the municipal advertising tax "appears to form part of a general system of domestic duties which is subject to objective, non-discriminatory criteria and also does not discriminate between domestic and cross-border activities."[526] Second, by its very wording, Article 56 TFEU requires the elimination of any restriction on the freedom to provide services, even if it applies to national providers of services and to those of other Member States alike, when it is liable to prohibit, impede or render less attractive the provision or receipt of cross-border services. In this respect, AG Kokott noted that the question of whether the imposition of an indiscriminately applicable duty, for example a tax, can be considered as a restriction in itself has not been clearly answered

of disadvantage concerns a taxpayer's claim relative to the tax legislation of another Member State.

519 Kingston 2007.

520 Banks 2007, p 44-45. This is also emphasized by Kokott & Ost 2011, p 498.

521 Case C-76/90 *Säger*, § 12.

522 Aujean has suggested that ECJ case law on direct taxation may find itself in a "transitional phase" towards a general *prima facie* prohibition on non-discriminatory tax obstacles"; see Aujean 2007, p 324.

523 Case C-433/04 *Commission v. Belgium*.

524 Case C-293/06 *Deutsche Shell GmbH*.

525 Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*.

526 Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 56-57.

in the existing case law.[527] According to the AG, there are two conceivable solutions: i) the justification solution: a non-discriminatory domestic duty may constitute a *prima facie* restriction and its justification must be examined, and ii) the definition-based solution: a non-discriminatory domestic duty is excluded from the scope of the fundamental freedoms from the outset. The AG does not make a fundamental choice for either of those options but concludes that both alternatives lead *in casu* to the same conclusion: the municipal advertising tax does not constitute a prohibited restriction on freedom to provide services. In respect of the 'justification solution', the AG noted that it cannot be disputed that even the simple imposition of a duty may make an economic activity more expensive and therefore less attractive. As a consequence, all duties, no matter what kind, would have to be examined against EU law; the Member States would then potentially be required in each individual case to show that their duties were justified for compelling reasons in the general interest, i.e. reasonable, necessary and proportionate with the aims pursued. It has to be borne in mind, however, that it could not be the task of the ECJ to second-guess Member States' budgetary decisions.[528] This leads the AG to the conclusion that "[i]f the justification solution is adopted, the municipal advertising tax would indeed be a restriction of freedom to provide services, but it could at the same time be justified without difficulty. According to all the available information, this – low – tax does not have a prohibitive effect and it is not clear to what extent the national and the local legislator might have exceeded their broad margin of discretion in budget policy in setting the tax."[529] The 'definition-based solution' starts from the assumption that the imposition of non-discriminatory taxes is not prohibited, and does not have to be justified in each individual case.[530] Indeed, according to the AG, "[i]f the definition-based solution is adopted, an indirect tax which forms part of a general system of domestic duties, is subject to objective, non-discriminatory criteria and also does not discriminate between domestic and cross-border activities does not fall within the scope of [the fundamental freedoms]".[531] The ECJ agreed with AG Kokott that the municipal advertising tax was allowed to stand:

> "37. With regard to the question of whether the levying by municipal authorities of a tax such as the advertising tax constitutes an impediment incompatible with [freedom to provide services], it must first of all be noted that such a tax is applicable without distinction to any provision of services entailing outdoor advertising and public bill-posting in the territory of the municipality concerned. The rules on the levying of this tax do not, therefore, draw any distinction based on the place of establishment of the provider or recipient of the bill-posting services or on the place of origin of the goods or services that form the subject-matter of the advertising messages disseminated.
> 38. Next, such a tax is applied only to outdoor advertising activities involving the

[527] Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 58-60.
[528] Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 61-63.
[529] Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 66.
[530] Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 64-65.
[531] Opinion AG Kokott in Case C-134/03 *Viacom Outdoor*, § 66.

> use of public space administered by the municipal authorities and its amount is fixed at a level which may be considered modest in relation to the value of the services provided which are subject to it. In those circumstances, the levying of such a tax is not on any view liable to prohibit, impede or otherwise make less attractive the provision of advertising services to be carried out in the territory of the municipalities concerned, including the case in which the provision of services is of a cross-border nature on account of the place of establishment of either the provider or the recipient of the services."

Thus, the ECJ has not explicitly decided in favour of the AG's 'justification solution' or 'definition-based solution'. Rather, the ECJ observed that the tax does not discriminate against cross-border activity *and* that the tax is applicable without distinction to any provision of services entailing outdoor advertising and public bill-posting and is fixed at a level which may be considered modest in relation to the value of the services. It can be concluded, however, that the ECJ is of the opinion that taxation *as such* does not amount to a *prima facie* restriction on free movement.

Mobistar

This conclusion is supported by *Mobistar*. This case concerned two Belgian local taxes, one on transmission pylons, masts and antennae for GSM, and the other on external antennae. The tax was set at a fixed amount per pylon, mast or antenna, and was payable by their owner. The ECJ decided that these taxes do not amount to a *prima facie* restriction on freedom to provide services:

> "31. (…) measures, the only effect of which is to create *additional costs in respect of the service in question* and which affect in the same way the provision of services between Member States and that within one Member State, do not fall within the scope of [freedom to provide services].
> 32. As regards the question whether the levy by municipal authorities of taxes such as those in question in the main proceedings amounts to a restriction incompatible with [freedom to provide services], it is necessary to point out that such taxes apply *without distinction to all owners of mobile telephone installations within the commune in question*, and that foreign operators are not, either in fact or in law, more adversely affected by those measures than national operators.
> 33. Nor do the tax measures in question make cross-border service provision more difficult than national service provision. Admittedly, introducing a tax on pylons, masts and antennae can make tariffs for mobile telephone communications to Belgium from abroad and vice versa more expensive. However, national telephone service provision is, to the same extent, subject to the risk that the tax will have an impact on tariffs.
> 34. It is appropriate to add that there is nothing in the file to suggest that the cumulative effect of the local taxes compromises freedom to provide mobile telephony services between other Member States and the Kingdom of Belgium."[532]

[532] Joined Cases C-544/03 and C-545/03 *Mobistar*. Italics by the author.

Thus, in *Mobistar* there were no disadvantages within the tax system at issue. Also, there was no discrimination against cross-border services. The only effect of the tax was that additional costs were raised for all economic operators in question. As a consequence, the ECJ did not find a *prima facie* restriction on freedom to provide services to be present.

Carbonati Apuani
The case of *Carbonati Apuani* did concern a prohibited tax measure. It concerned a municipal tax on marble which leaves the community of Carrara regardless of its destination (Italy or abroad). The ECJ held that this tax constitutes a *prima facie* restriction on free movement of goods (a charge having effect equivalent to a customs duty on exports within the meaning of Article 28 TFEU).[533] The ECJ stated that the very principle of a customs union requires the free movement of goods to be ensured within the union generally, not in trade between Member States alone, but more broadly throughout the territory of the customs union. The ECJ subsequently noted that this view is supported by Article 26(2) TFEU which defines the internal market as 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured', without drawing any distinction between inter-State frontiers and frontiers within a State.[534] This judgment does not mean that the ECJ is prepared to accept that taxation as such constitutes a restriction on free movement. Rather, the exemption of excavated marble used in the municipality itself constituted an advantage and a corresponding disadvantage for 'exported' marble which taxpayers can claim back.

Sea-Land
This case concerned the Dutch *Scheepvaartverkeerswet* (Shipping Act) which provided, in the framework of the vessel traffic services system (VTS system), for the introduction of a tariff for those services (VTS tariff). The VTS tariff was paid only by sea-going vessels. It is intended to serve as payment for vessel traffic services rendered by the State. An administrative decree determined the shipping lanes to which the tariff applies, the criteria for applying that tariff and derogations. Under this decree the VTS tariff is not payable, *inter alia*, for ships whose length does not exceed 41 metres. Sealand Service Inc. and Nedloyd Lijnen BV, supported by the Commission, claimed that the VTS system indirectly discriminates against them on the grounds of nationality, since the overwhelming majority of inland waterway traffic, which is exempt from the VTS tariff, takes place under the Netherlands flag. Ships flying the flag of a Member State are generally operated by national economic operators, whereas shipping companies from other Member States as a rule do not operate vessels flying this flag. The ECJ disagreed: "there are in this case objective differences between sea-going vessels longer than 41 metres and inland waterway vessels, in particular as concerns their respective markets - differences which reveal, moreover, that those two categories of means of transport are not comparable."[535] The ECJ did agree, however, with Sealand's argument that the tariff constituted a *prima facie* non-

[533] See for a similar conclusion in the area of freedom to provide services Case C-169/08 *Presidente del Consiglio dei Ministri v. Regione Sardegna*, § 30.
[534] Case C-72/03 *Carbonati Apuani*, § 22-24.
[535] Joined Cases C-430/99 and C-431/99 *Sea-Land*, § 37.

discriminatory restriction on freedom to provide services: "the VTS system at issue in the main proceedings, in that it requires the payment of a tariff by sea-going vessels longer than 41 metres, is liable to impede or render less attractive the provision of those services and therefore constitutes a restriction on their free circulation".[536] Banks fears that on this basis, every tax is a restriction on free circulation and can only survive scrutiny under EU law if it is a justified tax.[537] In my view, however, the approach taken by the ECJ can be explained by acknowledging that the VTS tariff was, as a result of derogations from the main rule, in the end only payable by sea-going vessels longer than 41 metres. This is a disadvantage relative to the exemption for shorter vessels. It does not necessarily mean that taxation *as such* is a restriction on free movement.

Sandoz

This case concerned the Austrian law on stamp duties which stated that legal transactions were subject to stamp duty if they are recorded in a written instrument. The law distinguished between the case where the instrument is drawn up abroad and the case where it is drawn up in Austria.[538] If the instrument is drawn up in Austria, the duty is payable either when it is signed by the contracting parties or when it is issued or sent by one of the signatories. However, if the instrument is drawn up abroad, the requirement to pay the duty concerned is dependent on certain conditions being met ensuring that a particular connection exists with Austria. If the contracting parties are Austrian residents and the subject-matter of the contract has some connection with Austria (e.g. where a loan is intended to provide funding for an operation which will take place in Austria or if the borrower is resident in Austria) the requirement to pay the duty arises at the time when the written agreement is concluded abroad. If one or both of the parties are non-residents, the duty is payable when the instrument concerned enters Austria. In short, if the instrument is drawn up abroad, the duty is payable only if certain conditions are met. In the case of legal transactions binding on both parties, the signatories to the instrument are jointly liable to pay the duty. Loan agreements are subject to stamp duty at the rate of 0.8% of the value of the loan. The ECJ held that the levying of stamp duty, also in cases where the lender is established outside Austria, constitutes a *prima facie* restriction on free movement of capital:

> "As the Advocate General points out at paragraphs 31 and 48 of his Opinion, legislation such as that at issue in the main proceedings deprives residents of a Member State of the possibility of benefiting from the absence of taxation which may be associated with loans obtained outside the national territory. Accordingly, such a measure is likely to deter such residents from obtaining loans from persons established in other Member States".[539]

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536 Joined Cases C-430/99 and C-431/99 *Sea-Land*, § 38.

537 Banks 2007, p 28.

538 The following summary of the Austrian law is derived from AG Léger's Opinion in this case (C-439/97 *Sandoz*).

539 Case C-439/97 *Sandoz*, § 19.

Advocate General Léger had noted that "[t]he principle of the free movement of capital was introduced *inter alia* in order to enable Community nationals to enjoy the most favourable conditions for investing their capital available to them in any of the States which make up the Community."[540] Paragraph 48 of the Opinion of Advocate General Léger, to which the ECJ refers, reads:

> "It is clear that the national law at issue does not prevent Austrian residents from taking out a loan from a foreign lender nor does it impose on them stricter conditions than if they were borrowing from an Austrian lender. However, it does deprive them of the opportunity of being exempt from duties, which would be available to them if they took the loan out abroad. A measure which involves a Member State offering persons taking out a loan exemption from duty is likely to persuade an individual or a company to take out a loan from an institution located in a State which offers this type of tax advantage or exemption."

This did not mean, however, that the Austrian rule was ultimately prohibited, because the ECJ held that the restriction was justified. It observed that the main objective of the legislation – which, irrespective of the nationality of the contracting parties or of the place where the loan is contracted, applies to all natural and legal persons resident in Austria who enter into a contract for a loan – is to ensure equal tax treatment for those persons. Since the effect of such a measure is to compel such persons to pay the duty, it prevents taxable persons from evading the requirements of domestic tax legislation through the exercise of freedom of movement of capital. Also, the Austrian legislation did not constitute a means of arbitrary discrimination because it applies to all borrowers resident in Austria without distinction as to nationality or the place where the loan was contracted.[541] According to Banks the ECJ wrongly decided that this "perfectly neutral tax measure" – cross-border situations are treated equally if not better than domestic situations – constitutes a *prima facie* restriction on free movement of capital.[542] In my view, however, the ECJ only *in form* applied a somewhat different approach in *Sandoz* in comparison with *Mobistar*: the end result in both cases was exactly the same.[543]

Commission v Belgium

This case concerned the following situation. In Belgium, the provision of services in the construction sector by natural or legal persons was, in principle, subject to a requirement of registration as a 'contractor' with one of the provincial commissions responsible for registration.[544] Operators who are not registered in Belgium were not excluded from

[540] Opinion AG Léger in Case C-439/97 *Sandoz*, § 47.

[541] Case C-439/97 *Sandoz*, § 24-26.

[542] Banks 2007, p 37.

[543] Compare also Case C-512/03 *Blanckaert*, where the ECJ first considered that a *prima facie* restriction on free movement of capital existed (§ 38-39) and subsequently considered – performing justification analysis – that resident and non-resident taxpayers were objectively different in view of the rule in question which provided a tax credit to taxpayers socially insured in the Netherlands (§ 50).

[544] Opinion AG Tizzano in Case C-433/04 *Commission v. Belgium*, § 5.

access to the national market but they were subject to special tax arrangements. Those provisions included two measures designed to guarantee that such individuals pay their taxes. In the first place, by having recourse to suppliers who are not registered in Belgium, the recipient of the services provided was considered to be jointly and severally liable for the payment of any tax debts of its own contracting partner. Such a liability is particularly broad in scope, since it applies, up to a level equivalent to 35% of the cost of the work commissioned, to 'all' the supplier's tax debts, including those relating to 'taxable periods' prior to the contract in question. Secondly, there was an obligation to withhold for a certain period 15% of the amount invoiced by unregistered construction companies.[545] The ECJ has held that these requirements constitute restrictions on the freedom to provide services. It recalled its consistent case law that Article 49 EC (freedom to provide services; Article 56 TFEU) requires not only the elimination of all discrimination on grounds of nationality against service providers who are established in another Member State, but also the abolition of any restriction on the freedom to provide services, even if it applies without distinction to national providers of services and to those of other Member States, which is liable to prohibit, impede or render less advantageous the activities of service providers from other Member States who lawfully provide similar services in their Member State of origin. The ECJ subsequently noted that the fact that the principal or contractor must withhold for the Belgian authorities a sum equivalent to 15% of the price charged by an unregistered service provider effectively deprives that provider of the ability immediately to have at his disposal a part of his income, which he can recover only at the conclusion of a specific administrative procedure. The ECJ then held that "[t]he disadvantages that the withholding obligation represents for service providers who are not registered and not established in Belgium are, consequently, liable to deter them from accessing the Belgian market in order to provide services in the construction sector in that country." Also, the fact that the principal or the contractor who contracts with a service provider not registered in Belgium is made jointly liable for all of that provider's tax debts relating to earlier taxable periods at the rate of 35% of the price of the work to be carried out is liable to deter that principal or contractor from having recourse to the services of a provider who is not registered and not established in Belgium, yet who lawfully provides identical services in his Member State of establishment. "Even if joint liability applies without distinction when an unregistered service provider is used, regardless of whether he is established in Belgium or in another Member State, it must nevertheless be stated that, while it does not deprive service providers who are not registered and not established in Belgium of the ability to supply their services there, the disputed provision does make access to the Belgian market difficult for them."[546]

It is clear that *Commission v Belgium* has not been decided on the basis of any discrimination analysis. It is important to note that the ECJ started its reasoning by stating that measures which are liable to prohibit, impede or render less advantageous cross-border economic activities constitute *prima facie* restrictions, thereby referring to the landmark non-tax cases of *Säger* (C-76/90) and *Commission v France* (C-255/04). These cases expressly advocate a 'disadvantage' approach rather than discrimination analysis.

[545] Opinion AG Tizzano in Case C-433/04 *Commission v. Belgium*, § 28-29.
[546] Case C-433/04 *Commission v. Belgium*, § 27-31.

The ECJ then observed that the withholding obligation with respect to unregistered service providers leads to 'disadvantages' which are 'liable to deter them from accessing the Belgian market' even if the disadvantages apply to foreign and domestic unregistered service providers alike. This case seems to reveal a willingness of the ECJ to give meaning to the 'liable to prohibit, impede or render less advantageous' phrase through a disadvantage test in direct taxation cases. A caveat should however be made, because the ECJ could have achieved the same conclusions in *Commission v. Belgium* if it had applied a discrimination approach. As stated earlier, Belgian resident contractors were under the obligation of registration as a 'contractor' in order to be able to provide services lawfully. Non-resident contractors already lawfully provide services under the regulations of their home State. By requiring those non-resident contractors to register again in Belgium, the registration requirement was a criterion which *de facto* leads to indirect discrimination on grounds of nationality.

Deutsche Shell

In *Deutsche Shell* the ECJ also seems to have kept the possibility open to test tax rules against the free movement provisions even in the absence of discrimination of cross-border economic activity. This case concerned the refusal of deductibility in Germany of a currency loss suffered by an Italian permanent establishment of a company resident in Germany. In 1974, Deutsche Shell GmbH had set up a branch in Italy. The proceeds generated by that branch were recorded, in accordance with Italian law, in a commercial and tax account drawn up in Italian currency and, for Deutsche Shell, in a separate German commercial and tax account. Deutsche Shell provided its branch with start-up capital, which was entered in the separate German commercial and tax account with the DEM exchange rate prevailing at the time of each payment made in LIT. In 1992, Deutsche Shell transferred the assets of the branch to an Italian subsidiary; subsequently it sold the shares in that subsidiary to an independent third party. Between 1974 and 1992 the Italian Lira had lost value against the German mark. The currency loss on the start-up capital was not taken into account in Italy, as the profits of the Italian branch were calculated in the local currency. It was not taken into account in Germany either because all results from the Italian permanent establishment were exempt from German corporation tax under the applicable bilateral tax treaty. Deutsche Shell argued that this infringed its freedom of establishment.

In her opinion AG Sharpston observed that both the referring court and the parties to the case expressed doubts on the question of whether the exclusion of the currency loss from the German taxable basis discriminates against cross-border economic activity or not. These doubts were raised by the absence of true internal comparators: a German branch would never be given start-up capital in a foreign currency. The AG considered that the answer to this question is irrelevant. According to the AG, the decisive factor is not whether there has been discriminatory treatment, but whether the German national law produces a situation which has a restrictive effect on those who wish to exercise their freedom of establishment.[547] The AG then qualified the meaning of "restrictive effect" by examining whether Deutsche Shell had suffered a 'disadvantage'. What would be decisive

[547] Opinion AG Sharpston in Case C-293/06 *Deutsche Shell*, § 35-36.

is whether a company is disadvantaged in a cross-border situation. "The possibility that a company can be *disadvantaged* because a loss arising from an adverse currency fluctuation affecting transactions between it and a cross-border establishment is not taken into account when computing tax liability arises *only* where that company engages in cross-border establishment." The AG then noted that this disadvantage arises as a result of a currency loss that can be seen only in Germany, as a result of which it is attributable to the decisions of the German authorities and does not flow from the co-existence of two tax systems.[548]

The ECJ agreed with the AG's approach. Referring to Case C-55/94 *Gebhard* and Case C-442/02 *CaixaBank*, it reiterated that all measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be regarded as obstacles. The non-deductibility of currency losses "increases" the economic risks incurred by a company established in one Member State wishing to set up a body in another Member State where the currency used is different from that of the State of origin. In such a situation, not only does the principal establishment face the normal risks associated with setting up such a body, but it must also face an additional risk of a fiscal nature where it provides start-up capital for it. The ECJ referred in this context to § 43-44 of the AG's opinion where reference was made to the opinion of AG Lenz in *Halliburton* ("although that was a clear discrimination case, the proposition is general", AG Sharpston said). That paragraph reads as follows:

> "Every business which intends to set up a branch must also consider the costs and risks associated with the disposal of assets which comprise the whole or part of that branch. That normally includes the real property of a business, for it is part of its "permanent presence", which distinguishes activities connected with an establishment from those related to the provision of services. A business of that kind must consider the need to dispose of such property if there is a change in economic circumstances in relation to the time when the establishment was set up. Burdens which arise in that connection therefore affect, if only indirectly, the "taking up" of activities as self-employed persons within the meaning of [Article 49 TFEU] and thus, so far as concerns companies from other Member States, their previously defined freedom to set up branches."[549]

In addition, the ECJ observed in *Deutsche Shell* that because it exercised its freedom of establishment, Deutsche Shell suffered financial loss which was not taken into account either by the national tax authorities for the purposes of calculating the basis of assessment for corporation tax in Germany or with respect to the assessment for tax of its permanent establishment in Italy.[550] It is unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses which, by their nature, can never be suffered by the permanent establishment.[551]

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548 Opinion AG Sharpston in Case C-293/06 *Deutsche Shell*, § 41-42.
549 Opinion AG Lenz in Case C-1/93 *Halliburton*, § 18.
550 Case C-293/06 *Deutsche Shell*, § 28-31.
551 Case C-293/06 *Deutsche Shell*, § 44.

It is clear that *Deutsche Shell* is not based on a discrimination analysis, which is illustrated by the fact that the ECJ refers to *CaixaBank* (which was a market access case), but rather on a disadvantage approach. Again, however, a caveat should be made for two reasons. First, the exclusion of the currency loss from deductibility was laid down by a measure which legally only applied to cross-border activity (the measure was laid down in a tax treaty). Second, a measure which results in the non-deductibility of currency losses in fact discriminates against cross-border activity because the possibility of a currency loss is inextricably linked to cross-border establishment.[552] It is still unclear whether a 'disadvantage approach' will also be followed in cases where a certain tax disadvantage also occurs in purely domestic situations, although the above statement of AG Lenz in *Halliburton* – to which the ECJ has indirectly referred – may indicate that the ECJ is in principle willing to go down that lane.

8.2.2 Relation to the theoretical optimization model

8.2.2.1 A disadvantage test?

In respect of the first phase of the optimization model – the identification of a disadvantage – ECJ case law on disparities is in conformity with the model: in these cases there is no 'disadvantage' which can be optimized in the model. In respect of international juridical double taxation, the absence of rules for the avoidance of such double taxation amounts to an identifiable 'disadvantage' under phase 1 of the model (section 7.3.2). The end result is however in line with ECJ case law, because it would be a disrespectful application of the principle of free movement if a Member State were to be forced to relieve international juridical double taxation (section 7.4.3). In respect of the concept of discrimination against cross-border activity, there is *in form* a difference between the theoretical optimization model and the ECJ's approach in direct tax cases. The ECJ formally employs a threshold criterion (a comparability test) in many direct tax cases before proportionality analysis can be performed. In fact, however, the ECJ uses a disadvantage test: a rule which taxes cross-border activity at a higher level than domestic activity constitutes a *prima facie* restriction on free movement. It is only after this has been established that the ECJ examines whether the two situations are objectively comparable. This question must be answered in light of the object and purpose of the measure under consideration (see section 2.2.4).[553] This means that under current ECJ case law a tax disadvantage must be able to be explained by the (legitimate) object and purpose of the measure under consideration. This comes very close to the theoretical optimization model (phase 2: the requirement of a respectful aim). It is therefore not surprising that there is – apart from cases like *Columbus Container Services* and *D* – not much ECJ case law on direct taxation which directly contravenes

[552] See for a similar statement the judgment of the Swedish Supreme Administrative Court of 30 March 2009, No. 3264-05, in relation to the Swedish income tax system which restricts the deductibility of currency losses on capital to 70% of the loss. The Swedish Supreme Administrative Court decided that this rule contravenes freedom of establishment.

[553] Case C-418/07 *Société Papillon*, § 27. This approach is also apparent in Case C-231/05 *Oy AA*, § 38. See explicitly Case C-337/08 *X Holding*, § 22.

the theoretical assessment model as far as the scope of the free movement provisions is concerned. This is also true in respect of situations of 'dislocation' or 'fragmentation' of the tax base which the ECJ does not distinguish from the concepts of discrimination and disparity. In respect of non-discriminatory tax obstacles to free movement, ECJ case law neither expressly confirms nor rejects the 'disadvantage' test of the theoretical optimization model. All these observations will be explained in the following sub-sections.

8.2.2.2 Disparities

It has been explained in section 7.3.3 that the theoretical optimization model can only be applied in relation to tax measures which have been adopted by the Member State which is accused of restricting free movement. Therefore, the above-discussed case law of the ECJ on disparities is in line with the model (any disadvantage as a result of the fact that *disparities*, or variations, exist between discrete national tax systems is outside the scope of the free movement provisions).

8.2.2.3 International juridical double taxation

In the event that a disadvantage arises as a result of the fact that a taxpayer is exposed to direct taxation in two (or more) States in respect of the same income, the question arises of whether one of those States should provide for the avoidance of double taxation. In the framework of the development of a theoretical optimization model, the specific question arises of whether the absence of such a provision – and consequently full taxation in both States on the same income – can meaningfully be assessed in such a model. It has been submitted in section 7.4.3 that this question should ultimately be answered negatively. It has been observed there that international juridical double taxation arises as a result of the simultaneous application by States of nationality, residence and source as criteria to define their tax jurisdiction. The principle of free movement cannot, however, prescribe that a Member State only uses one criterion to define its tax jurisdiction on the ground that only in that scenario can the Member State not be accused of contributing to international juridical double taxation. The principle of direct tax sovereignty *prima facie* requires that a State is maximally free to adopt – within its domestic jurisdiction – measures of general tax and economic policy and to determine the objectives it wants to pursue through these measures.

This explains a case like *Van Hilten*. This case concerned a situation in which the Netherlands had defined its inheritance tax jurisdiction on the basis of the nationality of the testator. Van Hilten died on 22 November 1997. Of Netherlands nationality, she had been resident in the Netherlands until the start of 1988, then in Belgium and, from 1991, in Switzerland. Her heirs were assessed to pay inheritance tax calculated on the basis of Art. 3(1) of the Netherlands Succession Tax Law (*Successiewet* 1956). Under this, a Netherlands national, who, having resided in the Netherlands, dies within ten years of ceasing to so reside, is deemed to have been resident in the Netherlands at the time of death. The question arose as to whether or not this legislation is a restriction on the free movement of capital (Article 63 TFEU). The ECJ held that national legislation that provides that the estate of a national of a Member State who dies within ten years of ceasing

to reside in that Member State is to be taxed as if that national had continued to reside in that Member State, whilst granting relief in respect of the taxes levied in the Member State to which the deceased transferred his residence, is not a restriction on the free movement of capital.[554] By enacting identical taxation provisions for the estates of (1) nationals who have transferred their residence abroad and (2) of those who have remained in the Member State concerned, such legislation cannot discourage the former from investing in that Member State from another Member State nor the latter from doing so in another Member State from the Member State concerned. Nor can this reduce the value of the estate of a national who has transferred his residence abroad. The fact that the legislation covers neither nationals resident abroad for more than ten years nor those who have never resided in the Member State concerned is irrelevant. As it only applies to nationals of the Member State concerned, this is not a restriction on the free movement of capital of nationals of other Member States.[555] With regard to the differences in treatment, resulting from national legislation such as that in question, between residents who are nationals of the Member State concerned and those who are nationals of other Member States, the ECJ stated that it must be observed that these distinctions, for the purposes of allocating the powers of taxation, cannot be regarded as a discrimination prohibited by Article 63 TFEU. Rather, the restrictions are derived from the Member States' power to define, by a tax treaty or unilaterally, the criteria for allocating their powers of taxation.[556] In my view, the last observation of the ECJ can be explained by noting that it is not unreasonable that the Netherlands had chosen not to exercise tax jurisdiction over non-resident persons who do not have Netherlands nationality. After all, for the purposes of the allocation of powers of taxation, it is not unreasonable for the Member States to find inspiration in international practice and, particularly, the model conventions drawn up by the OECD. The Dutch legislation in question complies with the commentaries in the Model Double Taxation Convention concerning Inheritances and Gifts (Report of the Fiscal Affairs Committee of the OECD, 1982). Although the same commentaries state also that the scope can be extended to cover not only nationals of the State concerned but also residents who are not nationals of that State, the ECJ apparently held that it was not unreasonable not to extend this scope to non-nationals (which is, in my view, in line with general rules on legislative jurisdiction under customary international law: non-resident persons who do not have Netherlands nationality should not be taxed on their worldwide estate or income; see section 5.2). As a consequence of this reasonable choice, the Netherlands treated every testator *within its domestic jurisdiction*, which was delimited by several different criteria such as residence and nationality, equally.

It follows that the above-discussed case law of the ECJ on international juridical double taxation is in line with the model. As a consequence, the criticism of Kofler and Mason,[557] discussed in 2.2.5, seems to be unjustified. The same is true for Wattel's position that Member States are under the obligation to grant a tax credit for foreign withholding

[554] Case C-513/03 *Van Hilten*, § 45.
[555] Case C-513/03 *Van Hilten*, § 46.
[556] Case C-513/03 *Van Hilten*, § 47.
[557] Kofler & Mason 2007, p 79-81. See for a critical analysis also Snell 2007, p 360 *et seq.*

taxes on the basis of Case C-319/02 *Manninen*.[558] This case concerned Finnish legislation whereby Finland granted a full imputation tax credit to Finnish shareholders in respect of Finnish corporate income tax levied on profits distributed as dividends. No tax credit in respect of foreign corporate income tax levied on foreign-source profits distributed as dividends was, however, granted. The ECJ held that Article 56 EC (free movement of capital; Article 63 TFEU) required Finland to extend this tax credit to account for corporate income tax levied on dividends from another Member State - in this case, Sweden.[559] In the light of the theoretical assessment model, the view is erroneous that this would force a Member State to grant a tax credit to resident taxpayers in respect of foreign withholding tax on dividends levied by a source State.[560] In such a case the Member State has not chosen to have an imputation tax system, but merely a classical system of economic double taxation of dividends (see section 5.4.2). In such a case, there is no 'disadvantage' in a cross-border situation which can meaningfully be optimized: in both cases the residence State levies an equal amount of (corporate) income tax from the shareholder.[561] An obligation to refrain from taxing a resident shareholder in this situation would essentially prohibit taxation as such, which would be a disrespectful application of the principle of free movement.[562] To put it differently, the objective of *raising* public funds by taxing dividends with (corporate) income tax cannot be achieved by taxation in another State.[563] This fundamentally distinguishes *Manninen* from withholding taxes in a classical system, because the objective of *avoiding* economic double taxation by refraining from taxing the dividend in the hands of the shareholder can be achieved by extending the imputation system cross-border. This in no way disrespects the principle of tax sovereignty, because the ECJ fundamentally respects the fact that a Member State is completely at liberty to choose whether or not to have an imputation tax system. If it chooses to introduce such a system, however, it should not impose disadvantages in cross-border situations. The ECJ has therefore rightly decided in *Orange European Smallcap Fund* that a Member State which has a classical system has no obligation to refund foreign withholding tax on dividends paid to a resident shareholder.[564]

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558 Terra & Wattel 2008, p 402.

559 Opinion AG Geelhoed in Case C-446/04 *Test Claimants in the FII Group Litigation*, § 44.

560 Wattel calls this a "mutual recognition of withholding taxes" in the event that a Member State grants a tax credit for domestic withholding tax against (corporate) income tax; Terra & Wattel 2008, p 402.

561 In domestic cases, a withholding tax is only a mechanism to levy (corporate) income tax from the shareholder at an earlier point in time.

562 See explicitly Case C-336/96 *Gilly*, § 48.

563 This is what the ECJ means in Case C-513/04 *Kerckhaert and Morres,* § 19, where it states that the position of a shareholder receiving dividends is not necessarily altered merely by the fact that he receives those dividends from a company established in another Member State which, in exercising its fiscal sovereignty, makes those dividends subject to a deduction at source by way of income tax.

564 C-194/06 *Orange European Smallcap Fund*, § 34 *et seq.*

8.2.2.4 Measures for the avoidance of international juridical double taxation

In section 8.2.1.4, the cases of *De Groot*, *AMID* and *Mertens*, *Seabrokers, Krankenheim Ruhesitz am Wannsee*, and *Orange European Smallcap Fund* have been discussed. In all of these cases the ECJ decided that, although double taxation is not *as such* contrary to the EU free movement provisions, a Member State cannot disregard these provisions once it has implemented measures for the avoidance of international juridical double taxation. This is fully in line with the theoretical optimization model.[565] The optimization of measures implemented by Member States is in no way disrespectful towards the principle of tax sovereignty: the choices made by a Member State in the exercise of its tax sovereignty are fully respected. The Dutch wish to avoid double taxation in *De Groot* was fully respected; also, after the Netherlands had been obliged to design those rules in accordance with the notion of ability to pay which underlay its income tax system, the scope of application of this notion was underinclusive (phase 4 of the model). The absence of rules in *AMID* and *Mertens* which allow for the carry-over of positive foreign source income in situations where the foreign income is positive and the domestic income is negative, as a result of which no effective exemption can be given in that year, could not be explained by the wish to achieve a balanced allocation of taxing powers between the Member States, because it resulted in taxation by Belgium of foreign profits not taxable in Belgium under the applicable tax treaty. Again, the Belgian wish to divide tax jurisdiction was fully respected, even after Belgium had been obliged to introduce rules for the carry-over of foreign profits. This was also the case in *Seabrokers*: in view of the objective of achieving a balanced allocation of taxing powers between Norway and the United Kingdom, the allocation of interest expenses unrelated to foreign income and group contributions could be taken out without harming the objectives pursued in the exercise of Norway's tax sovereignty: the rules which linked costs to foreign income were overinclusive. The same is true for the case of *Deutsche Shell* (discussed in section 8.2.1.5). In view of the objective of avoiding international juridical double taxation it did not make sense to exempt currency results which can by definition never lead to double taxation in two jurisdictions: the German exemption rule was overinclusive in relation to its objective. The qualification by the ECJ in *Krankenheim* of the German recapture rule as a *prima facie* restriction on freedom of establishment can also be explained by the theoretical optimization model. This recapture leads to an identifiable disadvantage within the meaning of phase 1 of the mode, which has a respectful objective in view of the wish to divide tax jurisdiction, which is suitable, has a sufficient degree of fit, which is the most subsidiary means to achieve that objective, but which might be disproportionate in cases where a certain loss cannot be taken into account anywhere without this being the result of a mere disparity between tax systems.[566] The decisions in these aforementioned cases do not deny the taxing right of a Member State as such, but merely optimize the measures taken by the Member States in the exercise of their sovereignty. This makes it possible to eliminate a lot of 'disadvantages'. The case

[565] It is, therefore, remarkable that the ECJ seems to have had a different view in Joined Cases C−436/08 and C−437/08 *Haribo and Österreichische Salinen*, § 170-172.

[566] Compare for this notion of 'final' losses Case C-446/03 *Marks & Spencer* and Case C-414/06 *Lidl Belgium*.

of *Orange European Smallcap Fund* can also be explained by the theoretical optimization model. The ECJ essentially decided that it is not contrary to free movement to divide tax jurisdiction in bilateral tax treaties in respect of investments in one Member State, while still taxing the income from the same investments in another Member State. This disadvantage does not have a disrespectful objective: division of taxing powers is possible only if both Member States agree to a tax treaty. Thus, no optimization is possible. The end result of ECJ case law and the model is, therefore, the same.

It is less easy to explain the case of *Columbus Container Services* – also discussed in section 8.2.1.4 – by the theoretical optimization model. The unilateral German switch-over from the exemption rule to a credit mechanism in the case of low-taxed foreign permanent establishments of a German undertaking can undoubtedly be optimized under the model: it is an anti-abuse measure with a clear objective. The classification of the measure was clearly overinclusive in some situations (phase 4 of the model). The German switch-over could have been optimized against the free movement provisions without in any way harming the principle of German tax sovereignty. *Columbus* is, therefore, a wrong decision in the light of the model.

The case of *Haribo and Österreichische Salinen* is also difficult to explain in the light of the theoretical optimization model. It is difficult to see why the ECJ did not require a carry-forward of the foreign withholding similar to its decisions in *AMID* and *Mertens*. All of these cases concerned situations where the tax jurisdiction was divided by a tax treaty which, in principle, provided for the avoidance of international juridical double taxation. This objective could have been realized in *Haribo and Österreichische Salinen* by prescribing a carry-forward of the foreign withholding tax without harming the principle of direct tax sovereignty.

8.2.2.5 Discrimination

Introduction

Although the ECJ often formally uses a comparability test in order to assess whether a certain tax measure falls within the scope of the free movement provisions, there are in practice very few cases where the theoretical optimization model's 'disadvantage' test would have led to a different result. The line of reasoning, however, is sometimes a little different. This will be discussed now.

Disadvantageous treatment of cross-border movement

Legislative classifications on grounds of cross-border movement should theoretically be seen as a *prima facie* limit to the principle of free movement (section 7.3.2). In addition, any legislative classification which has the effect of discouraging cross-border activity should qualify as a *prima facie* limit. In principle, ECJ case law is in harmony with the model in this regard. For instance, a tax exemption based on the criterion that the company should employ at least five people in the territory of the Member State concerned leads to covert discrimination on grounds of nationality.[567] This evidences that the ECJ employs – in line with the theoretical optimization model – a broad interpretation of the concept

[567] Case C-464/05 *Geurts and Vogten*, § 19-22.

of discrimination on grounds of nationality and of the prohibition of obstacles to free movement. This is again underlined by the fact that the ECJ does not accept jurisdictional arguments *per se* in respect of the unequal treatment by the Member State of origin.

However, the case law which concerns equal treatment in the source State is problematic in view of the theoretical optimization model insofar as it excludes from the scope of the principle of free movement any negative items of income outside the scope of the source State's tax jurisdiction. The *Futura* case, discussed above, can serve as an example. *Futura Participations SA*, a company with its seat in Paris, had a Luxembourg branch, Singer. Futura sought to set off, for Luxembourg corporate income tax purposes, 'French' losses incurred by the head office against the profits of the Luxembourg branch. Under Luxembourg law, the losses must be economically linked to the income in Luxembourg, so that only losses arising from Futura's activities in Luxembourg could be considered. According to the ECJ, "such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination" prohibited by EU law.[568] Theoretically, it would have been better to qualify the Luxembourg measure as a *prima facie* restriction on freedom of establishment. Subsequently, it could have been observed that the restrictive measure had a legitimate objective: to preserve inter-nation equity (profits and losses of the head office should be taken into account in France only, both under customary international law and the applicable tax treaty). The restrictive measure has a sufficient degree of fit and is suitable to achieve its objective. As regards the question of whether the restrictive measure was the most subsidiary measure to achieve its objective, the ECJ could have stated that Luxembourg's apparent wish not to interfere in the domestic jurisdiction of France by allowing loss relief for one of its resident companies could not have been achieved by another, less burdensome measure (compare section 5.3). Finally, the last step of the theoretical optimization model should have been applied: the question of whether the cost to free movement caused by the tax measure is *in proportion* to the objectives pursued by it. Here the ECJ could have held that this cost is disproportionately high where the French head office losses cannot be taken into account locally.[569]

The *Schumacker*-doctrine is ultimately, in result, not problematic in relation to the theoretical optimization model. The reasoning which leads to that result would however have been different under the model. Contrary to the model, the ECJ has held that a rule which refuses a certain deduction for income tax purposes in relation to non-resident taxpayers does not constitute a *prima facie* restriction on free movement. It reasoned as follows. First, it stated that in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable. Then it considered:

> "32. Income received in the territory of a Member State by a non-resident is in most cases only a part of his total income, which is concentrated at his place of residence. Moreover, a non-resident' s personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is more easy to assess at the place where his personal and financial interests are centred. In general, that is the place where he has his usual abode. Accordingly,

[568] Case C-250/95 *Futura Participations SA and Singer*, § 22.
[569] Compare Case C-414/06 *Lidl Belgium*.

> international tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence.
> 33. The situation of a resident is different in so far as the major part of his income is normally concentrated in the State of residence. Moreover, that State generally has available all the information needed to assess the taxpayer's overall ability to pay, taking account of his personal and family circumstances.
> 34. Consequently, the fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayer are not in a comparable situation.
> 35. Accordingly, [Article 39 EC] does not in principle preclude the application of rules of a Member State under which a non-resident working as an employed person in that Member State is taxed more heavily on his income than a resident in the same employment.
> 36. The position is different, however, in a case such as this one where the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances.
> 37. There is no objective difference between the situations of such a non-resident and a resident engaged in comparable employment, such as to justify different treatment as regards the taking into account for taxation purposes of the taxpayer's personal and family circumstances.
> 38. In the case of a non-resident who receives the major part of his income and almost all his family income in a Member State other than that of his residence, discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment."[570]

Paragraph 38 in particular of the judgment has been criticized by Wattel,[571] who obviously has a point here. One cannot establish discrimination in the source State by referring to what the residence State has or has not done. The ECJ could however have achieved the same result if it had used the theoretical assessment model:

i. The refusal to allow a deduction related to personal circumstances for non-resident taxpayers constitutes a disadvantage for cross-border movement of workers.
ii. This *prima facie* restriction has a respectful aim, namely to give effect to practice in international tax law, reflected in the OECD Model Tax Convention, to allocate costs related to personal circumstances of a taxpayer to his State of residence.[572]

[570] Case C-279/93 *Schumacker*, § 30 *et seq.*
[571] Terra & Wattel 2008, p 392.
[572] See Case C-385/00 *De Groot* where the ECJ decided that these costs cannot be allocated by the

iii. The rule is suitable to achieve its objective.
iv. The rule which excludes deductibility has a sufficient degree of fit in relation to its objective.
v. The rule is the most subsidiary means to achieve its objective (allocation of the costs to the residence State).
vi. The rule is however disproportionate in relation to its objective insofar that the taxpayer is unable to claim an effective deduction in his State of residence, which is the case if a non-resident taxpayer receives the major part of his income and almost all his family income in a Member State other than that of his residence.

In this way, the ECJ could have avoided much of the criticism, because this approach shows a disadvantage from a source State's perspective. Also, it becomes clear that the judgment essentially applies the test of proportionality *stricto sensu*, thereby not overstepping the ECJ's competence.

The above-discussed case of *Renneberg* concerned a combination of *Futura* and *Schumacker*. To recall the facts, Mr. Renneberg lived in Belgium and worked in the Netherlands. His dwelling in Belgium was financed with a loan on which he paid interest. This interest could not be deducted in the Netherlands because the Belgium-Netherlands tax treaty allocated both positive and negative income from that dwelling exclusively to Belgium. The ECJ applied the *Schumacker*-doctrine to the negative income (i.e. the interest payments), notwithstanding the fact that this income was outside the source State's (the Netherlands') tax jurisdiction.[573] A person who derives most of his taxable income from salaried employment in another Member State and has no significant income in his Member State of residence is, for the purposes of taking into account his ability to pay tax, in a situation objectively comparable, with regard to his Member State of employment, to that of a resident of that Member State who is also in salaried employment there. Therefore, free movement of workers required the Netherlands to take Renneberg's negative income into account for the purposes of determining the basis of assessment of taxable income. The ECJ could also have achieved this result by using the theoretical optimization model:

i. The refusal to allow the interest deduction constitutes a disadvantage for cross-border movement of workers.
ii. This *prima facie* restriction has a respectful aim, namely to maintain a balanced allocation of taxing powers between the Member States: the allocation of income to the State where the real estate is located.
iii. The rule is suitable to achieve its objective.
iv. The rule which excludes deductibility has a sufficient degree of fit in relation to its objective.
v. The rule is the most subsidiary means to achieve its objective (allocation of the costs to the residence State).

State of residence to the source State. Compare also Case E-7/07 *Seabrokers* where the EFTA Court decided that the residence State can only allocate costs to the source State if those costs are *directly linked* to income in the source State. This is in line with Case C-234/01 *Gerritse* where the ECJ explained that only those costs fall with source State jurisdiction.

573 Case C-527/06 *Renneberg*, § 66-68.

vi. The rule is however disproportionate in relation to its objective insofar that the taxpayer is unable to claim an effective deduction in his State of residence, which is the case if a non-resident taxpayer receives the major part of his income in the State of employment.

This means that Kemmeren's criticism of this judgment – *Renneberg* would have concerned a case of dislocation of the tax base and not one of restriction of free movement of workers – is not justified by the theoretical assessment model.[574] Application of the model leads to a better optimization of the principles involved than the black-and-white approach of dislocation (section 8.2.2.6).

A difference between *Renneberg* and *Futura* is that the first case concerned a natural person who is taxed by taking into account his ability to pay, whereas the last case concerned a company which by definition has no personal circumstances.[575] If the ECJ had explained its reasoning in *Futura, Schumacker* and *Renneberg* in this way it would have been in line with the theoretical optimization model.

This would have been more difficult in the above-discussed case of *D*. To recapitulate, the ECJ refused to extend to other EU nationals the allowance granted by the Netherlands for its wealth tax, on the basis of a bilateral tax treaty, to residents of Belgium who own real property in the Netherlands. According to the ECJ, residents of Belgium were not comparable to other EU nationals because of the necessarily limited personal scope of the bilateral tax treaty. This is, however, a *petitio principii*: this was exactly the taxpayer's complaint.[576] Application of the theoretical optimization model would have produced the following reasoning:

i. There is disadvantageous treatment of a tax resident in another Member State than Belgium.
ii. This *prima facie* restriction on free movement of capital does not have a respectful aim, because the objective of the rule in the bilateral tax treaty which grants the advantage to residents of Belgium is discriminatory in itself.

The rule which granted the advantage did not have anything to do with the allocation of taxing rights between the Netherlands and Belgium.[577] It led to an advantage, within the Netherlands wealth tax jurisdiction with respect to real property located there, to certain taxpayers only. Contrary to the ECJ's decision, the reciprocity inherent in every bilateral tax treaty cannot justify this different treatment, because the rule in the tax treaty is discriminatory in itself and is, therefore, disrespectful towards the principle of free movement: its very aim is to grant an advantage to some taxpayers only in the market place (i.e. the tax jurisdiction as delimited by the tax treaty).[578] Thus, the case of *D* is a case of

[574] Kemmeren 2009.
[575] This may also explain the outcome in Case C-231/05 *Oy AA*: a restriction which is justified and not disproportionate.
[576] See Van Thiel 2005 for harsh but deserved criticism on this judgment.
[577] Hilling 2005, p 325, rightly points this out.
[578] Case C-376/03 *D. v. Inspecteur*, § 61.

which the result cannot be explained by the theoretical assessment model. It is, therefore, submitted that the *D* case was wrongly decided. The ECJ should have decided that the tax treaty rule led to a disadvantage for Mr. D which did not have a respectful aim.

Equal treatment in the Member State of origin: the cases of Cadbury Schweppes, FII, Columbus Container Services and Haribo

These cases – discussed in section 8.2.1.4 – require special attention, because they seem to be at odds with each other.[579] In *Cadbury Schweppes*, the ECJ held that the CFC legislation in question *prima facie* infringed freedom of establishment, because it did not apply to i) domestic subsidiaries and ii) foreign subsidiaries established in a Member State with a 'normal' tax rate. In *FII*, the ECJ held that an exemption system for domestic dividends and an imputation system for foreign dividends did not constitute an infringement of freedom of establishment or free movement of capital provided that the application of an imputation system also for domestic dividends would have had the same factual result as an exemption system. Clearly, this argument also applies to CFC legislation in domestic situations: this leads to the same effective tax burden as an 'exemption' of CFC legislation in situations where both the domestic parent company and the domestic subsidiary are subject to the same corporate income tax rules. In *Columbus*, the ECJ decided that the unilateral German switch-over from the exemption rule to a credit mechanism in the case of lowly taxed foreign permanent establishments of a German undertaking does not result in a *prima facie* restriction on freedom of establishment on the ground that a permanent establishment in a Member State with a 'normal' tax rate is not subject to the switch-over to the credit method. In *Cadbury Schweppes*, however, the ECJ had held that a similar difference between two foreign subsidiaries did constitute a *prima facie* restriction on freedom of establishment. In *Haribo*, the ECJ held – in the context of the Austrian system of avoiding economic double taxation on dividend payments – that the different treatment of income from one non–member State compared to income from another non−member State is not concerned, as such, by Article 63 TFEU. The ECJ did not, therefore, review whether the exemption of a dividend arising in one non-member State and the taxation of a dividend arising in another non-member State constitutes a restriction on free movement of capital.

The question arises as to how these judgments can be reconciled. It has been argued in section 8.2.2.4 that the switch-over rule in *Columbus* could undoubtedly have been optimized under the theoretical optimization model: it is an anti-abuse measure with a clear objective. The classification of the measure was overinclusive in some situations (phase 4 of the model). *Columbus* was, therefore, wrongly decided. The judgments in *Cadbury Schweppes* and *FII* can be distinguished from each other. The first case concerned a clear anti-abuse provision which can be optimized under the theoretical optimization model. The latter case concerned a general system for the avoidance of economic double taxation. Such a system is in principle allowed to stand, as long as it does not lead to a disadvantage for cross-border dividends. It is, therefore, not at odds with the theoretical optimization model that the ECJ concluded that the difference between domestic and foreign subsidiaries in *Cadbury Schweppes* led to a *prima facie* restriction on freedom of

[579] Compare Monsenego 2011, p 107 et seq. for a discussion.

establishment, whereas the distinction between domestic and foreign dividends in *FII* did not lead to a *prima facie* restriction. The case of *Haribo* cannot, however, be explained by the theoretical optimization model. The taxation of a dividend from a non-member State as compared to the exemption of a dividend from another non-member State constitutes a disadvantage with a clear anti-avoidance objective which is capable of being optimized under the model similar to the *Cadbury Schweppes* case.

Discrimination on grounds of legal form
It has been indicated in section 8.2.1.4 that ECJ case law tends towards a separate application of the criterion of free choice of legal form in direct taxation cases. On the basis of the theoretical optimization model, this should indeed be expected.

8.2.2.6 No dislocations

It follows from the account provided in 8.2.1 that the ECJ generally does not distinguish situations of 'dislocation' or 'fragmentation' of the tax base from the concepts of discrimination and disparity. Discrimination analysis is performed in respect of any rule which results in a disadvantageous treatment of cross-border activity.[580] This is fully in line with the theoretical optimization model which requires a 'disadvantage' test to be met, followed by an optimization process where black-and-white results are avoided. It follows that the criticism of the ECJ by Wattel[581] and Weber[582], discussed in section 2.2.5, is not justified by the model. After all, the model requires that the principles of free movement and tax sovereignty are optimized to the largest extent possible. The approach to stop this optimization process as soon as a 'dislocation' has been identified is not capable of reaching the optimum position between tax sovereignty and free movement.

8.2.2.7 Non-discriminatory tax measures

According to the theoretical optimization model, any direct tax measure which leads to a certain 'disadvantage' comes within its scope. This test merely serves to identify the disadvantage in question: which amount of tax should be refunded in case the court would find in favour of the taxpayer? Although direct taxation *as such* will not ultimately give rise to a prohibited restriction on free movement, provided that the taxation at issue does not render free movement illusionary, the question of how a certain tax measure should be optimized in view of the principle of free movement should *not* be verified in the first phase of the theoretical optimization model, but rather in all its subsequent phases (section 7.3). At present, the vast majority of ECJ case law in the field of direct taxation does not concern situations in which genuinely non-discriminatory tax measures were at issue. As a consequence, the ECJ has not been in the position to decide under which circumstances, if at all, a non-discriminatory tax measure can be tested for compatibility with the free movement provisions. The ECJ has always left it open as to whether it is prepared to test

[580] See Douma 2006.
[581] Wattel 2003, p 198 *et seq.*
[582] Weber 2007.

truly non-discriminatory tax rules which lead to a 'disadvantage'. The language used by the ECJ continues to use (also) the *Säger* formula involving national rules which are 'liable to prohibit or otherwise impede' economic activities, irrespective of any discrimination.[583] This is especially clear from the above-discussed case of *Commission v. Belgium*.[584] In my view, the above-discussed case of *Deutsche Shell*[585] provides a clear indication that the ECJ is willing to extend the scope of the free movement provisions beyond direct tax measures which discriminate against cross-border economic activity. This is notwithstanding the above-discussed cases of *Viacom Outdoor* and *Mobistar* (section 8.2.1), where the ECJ held that the non-discriminatory tax measures at issue did not constitute a restriction on free movement, because the 'disadvantage' in those cases would in any event have served a 'respectful' objective which cannot be optimized further under the model (section 7.4.2). The case of *Sandoz* confirms this because this is a case where the ECJ seems to have labelled a tax rule *as such* as a restriction on free movement, which was allowed to stand because of its wholly neutral application in the tax jurisdiction. Still, current ECJ case law is neither expressly confirming nor rejecting the 'disadvantage' test of the theoretical optimization model. On the basis of the theoretical optimization model it should be expected that the ECJ will confirm the 'disadvantage' test in future case law, as will be discussed now.

8.2.3 Future developments

8.2.3.1 Introduction

On the basis of the preceding section it should be expected that the ECJ will continue its position on disparities, international juridical double taxation and dislocations. In addition, it should be expected that the ECJ will also in form turn to an approach where every legislative classification or 'disadvantage' causes a *prima facie* infringement of free movement. Also, it should be expected that the ECJ will be prepared to review non-discriminatory tax obstacles to free movement. These two expectations are now discussed.

8.2.3.2 Moving away from a comparability test

It follows from the theoretical optimization model that the ECJ should not *formally* apply a comparability test in direct taxation cases as a gateway to the free movement provisions and the proportionality test.[586] Every 'disadvantage' caused by a direct tax rule in a cross-

[583] Case C-76/90 *Säger*, § 12.
[584] Case C-433/04 *Commission v. Belgium*.
[585] Case C-293/06 *Deutsche Shell GmbH*.
[586] It should be noted that there are many cases in which the ECJ refrains from performing such a test at the beginning of the legal reasoning; in these cases this test is performed in the stage between the finding of a *prima facie* restriction and justification analysis. Compare for example Case C-256/06 *Jäger*, where the ECJ first considered that the tax measure in question amounted to a *prima facie* restriction on free movement of capital and subsequently examined whether the domestic and cross-border situation were objectively comparable. See also Case C-337/08 *X Holding*, § 20.

border situation should be within the scope of these provisions. It has been argued in section 8.2.2 that the case law which concerns equal treatment in the source State is problematic in view of the theoretical optimization model insofar as it excludes from the scope of the principle of free movement any negative items of income outside the scope of the source State's tax jurisdiction (the *Futura* and *Schumacker* case law), although – as explained above – the 'scoping-out' by the ECJ may be more of an academic than a practical nature. The recent case C-527/06 *Renneberg*, also discussed above, seems to have aligned the case law with the theoretical optimization model. It may on grounds of the model be expected that the ECJ will further pursue this route. As a consequence, it should be expected that the ECJ will bring any direct tax rule which makes a distinction on grounds of cross-border movement within the scope of free movement, the nature or reason for the distinction being immaterial at that stage.

8.2.3.3 Non-discriminatory tax obstacles to free movement

Introduction

It has been argued in section 8.2.2.7 that it is at present unclear under which circumstances, if at all, a non-discriminatory tax measure can be tested for compatibility with the free movement provisions. On the basis of the theoretical optimization model it should be expected that the ECJ will bring any direct tax rule which applies in cross-border situations within the scope of the free movement provisions.[587] As mentioned previously, the direct tax cases of *Deutsche Shell* and *Commission v. Belgium* are indications to this effect.

A further illustration is provided by settled case law outside the area of taxation.[588] In *Säger*, the ECJ held that the free movement provisions require not only the elimination of all discrimination on grounds of nationality but also the abolition of any restriction, when it is liable to prohibit or otherwise impede economic activities.[589] A national measure which is liable to prohibit or otherwise impede economic activities restricts free movement *even in cases where there is no allegation of discrimination on grounds of nationality*.[590] The alleged 'problem' with this formulation is that it makes no reference to the size or scale of the impediment: it is sufficient that there is one or liable to be one (there is no *de minimis* rule).[591] According to AG Tizzano, the absence of a borderline would result in "a market in which rules are prohibited as a matter of principle, except for those necessary and proportionate to meeting imperative requirements in the public interest."[592] Ultimately, in the words of AG Tesauro, the question is whether EU free movement is "intended to liberalize intra-Community trade or (…) more generally to encourage the unhindered pursuit of commerce in individual Member States".[593]

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587 Kokott and Ost 2011 do not exclude a development to this effect.

588 See the insightful article by Snell 2010.

589 Case C-76/90 *Säger*, § 12. See also Case C-19/92 *Kraus*; Case C-55/94 *Gebhard*, § 37, and more recently Case C-298/05 *Columbus Container Services*, § 34, and the case law cited there.

590 Case C-169/07 *Hartlauer Handelsgesellschaft*, § 33, and the Opinion of AG Sharpston in case Case C-96/08 *CIBA*, § 39.

591 See Barnard 2010, p 258. Compare Case C-233/09 *Dijkman*, § 42.

592 Opinion AG Tizzano in Case C-442/02 *CaixaBank France*, § 63.

593 Opinion AG Tesauro in Case C-292/92 *Hünermund*, § 1.

Indeed, as Snell has said, "[t]he most fundamental question for free movement law remains whether the law is about discrimination and anti-protectionism, in which case a relative or comparative test based on a perceptible disparate impact is appropriate, or whether it is about economic freedom, in which case an absolute test not involving comparisons is necessary."[594] In order to avoid this stark choice, several AG opinions have made a distinction between national measures which restrict *access to* and *exercise of* an activity respectively. According to Snell, the notion of market access envisages "a third way between anti-protectionism and economic freedom."[595] The meaning of this distinction is, however, by no means clear and has so far not expressly been applied by the ECJ in cases concerning free movement of persons, services and capital, although the term 'market access' is often mentioned. On the contrary, the ECJ has in some cases refused to apply the concept of market access. In recent case law, the ECJ seems to have focused more on the degree to which national measures affected free movement. The present section will discuss these developments. It will be concluded that they are supported by the theoretical optimization model and that a similar development should be expected in direct taxation cases.

A distinction between access to and exercise of an activity?

In *Bosman*, AG Lenz suggested that the ECJ draw a distinction between measures which regulate access to activity and measures which are directed more to the exercise of that activity.[596] AG Fenelly supported this approach in *Graf*. In his view, "the imposition of conditions regarding entry to the market or the taking up of economic activity is itself sufficient to establish the existence of a restriction, even if the condition can be relatively easily satisfied (this being an element in determining whether or not the restriction is justified). The same, broadly speaking, can probably also be said of formal conditions imposed regarding matters which are intimately connected with successful access to the market, such as those governing recognition of a qualification which is necessary or beneficial to the exercise of many professional activities."[597] If, however, "it were proposed to treat as restrictions on the exercise of freedom of movement neutral national rules which allegedly preclude, deter, impede, hinder or render less attractive such exercise simply by raising material barriers, for example, by establishing commercial and regulatory conditions in the market in question which are less enticing than in other Member States, or by offering benefits which would be lost in the event that a worker changed employment, those criteria could not be applied in the same way as in the case of a formal condition". Such rules should in the view of the AG only amount to a restriction on free movement in the case of a direct effect on access to the market in question "if the Treaty is not to be exploited as a means of challenging any national rules whose effect is simply to limit commercial freedom." Thus, "neutral national rules could only be deemed to constitute material barriers to market access, if it were established that they had actual effects on

[594] Snell 2010, p 470. See also Maduro 1998, p 58-60.
[595] Snell 2010, p 471.
[596] Opinion AG Lenz in Case C-415/93 *Bosman*, § 205.
[597] Opinion AG Fenelly in Case C-190/98 *Graf*, § 30.

market actors akin to exclusion from the market."[598] AG Alber does not agree with the approach taken by AG Lenz and AG Fenelly. In *Lehtonen*, he stated that the filter of the distinction between access to and exercise of an activity is not necessary outside the free movement of goods.[599]

Snell has criticised the "superficial appeal" of the distinction between access and exercise. First, the normative justification for the approach would be dubious. "Whether or not the limitation of economic freedom operates at the access stage or at the exercise state is irrelevant, all that matters is how much the profitability is reduced." To put it differently, "the impact of a measure on cross-border situations is a function of its restrictiveness, and does not depend on the stage at which it operates." The effect on free movement is the same.[600] Second, the distinction is difficult to apply in practice.[601] Third, the language of Article 49(2) TFEU seems to require a similar approach to access and exercise regulations.[602] Snell emphasizes that the ECJ has not accepted the difference either. *Commission v. Denmark*[603] is an example. A resident of Denmark was entitled in principle to use in Denmark only a vehicle registered in that Member State and provided with registration plates before use. The registration of a vehicle in Denmark is subject to payment of a registration tax. In later legislation this requirement was softened. First, according to the amended scheme, a vehicle registered in another Member State no longer had to be registered with Danish registration plates. Second, the amended scheme provided that the registration tax no longer had to be paid at the full rate, but on a *pro-rata* basis according to the amount of time the vehicle is used in Denmark. Under 'the temporary registration tax' the Danish customs and tax authorities may, on request, authorize payment of registration tax for taxable motor vehicles which are registered for temporary use in Denmark *inter alia* if the motor vehicle is made available by a company or a fixed establishment located abroad to a person resident in Denmark for business and private use in the foreign country concerned and in Denmark, where the employment by the undertaking or the fixed establishment constitutes that person's principal employment. The person who makes the vehicle available to the person resident in Denmark shall in that case be liable for payment of the tax. The Commission argued that the Danish rules constituted restrictions on free movement of workers on the ground that both the original scheme and the amended scheme have the effect of hindering the right of employees to seek employment in another Member State and the freedom of employers in other Member States to take on employees resident in Denmark. The ECJ found in favour of the Commission. It noted that the Danish tax legislation falls within the scope of free movement. The provisions on freedom of movement for persons are intended to facilitate the pursuit by EU citizens of occupational activities of all kinds throughout the Union, and preclude measures which might place EU citizens at a "disadvantage" when they wish to pursue an economic activity in the territory of another Member State, even if they apply

598 Opinion AG Fenelly in Case C-190/98 *Graf*, § 30-31.
599 Opinion AG Alber in Case C-176/96 *Lehtonen*, § 48-49.
600 Snell 2010, p 445.
601 Snell 2010, p 445-446.
602 Snell 2010, p 446.
603 Case C-464/02 *Commission v. Denmark*.

without discrimination. The ECJ then noted that, in order to be capable of constituting such an obstacle, they must affect access of workers to the labour market. The ECJ then said that "legislation which relates to the conditions in which an economic activity is pursued may constitute an obstacle to freedom of movement", from which it follows "that the Danish legislation at issue in this case is not excluded from the outset from the scope of [Article 45 TFEU]."[604] It is noteworthy that the ECJ explicitly states that tax legislation – which in my view necessarily relates to the conditions in which an economic activity is pursued – falls within the scope of the free movement provisions. Within this scope 'measures which might place EU citizens at a disadvantage when they wish to pursue an economic activity in the territory of another Member State' are in principle precluded. The ECJ found that the Danish legislation leads to such a disadvantage and constitutes a *prima facie* restriction on free movement of workers.[605]

Free movement of goods: the Keck doctrine and subsequent developments

In its famous judgment in *Keck*, the ECJ embraced a distinction between product rules and selling arrangements.[606] The case concerned a French prohibition on supermarkets reselling products at a loss. The ECJ observed that national legislation imposing a general prohibition on resale at a loss is not designed to regulate trade in goods between Member States (§ 12). Although such legislation may restrict the volume of sales, and hence the volume of sales of products from other Member States, the question remained of whether such a possibility is sufficient to characterize the legislation in question as a measure having equivalent effect to a quantitative restriction on imports (§ 13). In view of the increasing tendency of traders to invoke Article 34 TFEU as a means of challenging any rules whose effect is to limit their commercial freedom even where such rules are not aimed at products from other Member States, the ECJ considered it necessary to re-examine and clarify its case-law on this matter (§ 14). It held that, in the absence of harmonization of legislation, obstacles to free movement of goods which are the consequence of applying, to goods coming from other Member States where they are lawfully manufactured and marketed, rules that lay down requirements to be met by such goods (such as those relating to designation, form, size, weight, composition, presentation, labelling, packaging) constitute measures of equivalent effect prohibited by Article 34 TFEU. This is so even if those rules apply without distinction to all products unless their application can be justified by a public-interest objective taking precedence over the free movement of goods (§ 15). By contrast, the application to products from other Member States of national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade between Member States, so long as those provisions apply to all relevant traders operating within the national territory and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States (§ 16). Provided that those conditions are fulfilled, the application of such rules to the sale of products from another Member State meeting the requirements laid down by that State is not by nature such as to prevent their access to the market or

[604] Case C-464/02 *Commission v. Denmark*, § 34-38.
[605] Case C-464/02 *Commission v. Denmark*, § 45-50.
[606] Joined cases C-267/91 and C-268/91 *Keck and Mithouard*.

to impede access any more than it impedes the access of domestic products. Such rules therefore fall outside the scope of Article 34 TFEU (§ 17). As a consequence, the French prohibition was allowed to stand.

Snell has observed that, after *Keck*, Article 34 TFEU is concerned with two types of measures - first, the category of rules which prevent the importation of products from other Member States, and second, the category of rules which hinder imports more than national products, i.e. rules which discriminate. Indeed, as Snell has argued, it is difficult to see what the notion of market access adds to this.[607] In *Commission v. Italy (trailers)*, the ECJ seems to have interpreted the notion of market access by embracing the idea of a 'substantial hindrance'.[608] This case concerned an Italian prohibition on a motorcycle towing a trailer without regard to the origin of the trailer. The ECJ noted that a prohibition on the use of a product in the territory of a Member State has a considerable influence on the behaviour of consumers, which, in its turn, affects the access of that product to the market of that Member State (§ 56). Consumers, knowing that they are not permitted to use their motorcycle with a trailer specially designed for it, have practically no interest in buying such a trailer. Thus, the prohibition prevents a demand from existing in the market at issue for such trailers and therefore hinders their importation (§ 57). It followed that the prohibition, "to the extent that its effect is to hinder access to the Italian market for trailers which are specially designed for motorcycles and are lawfully produced and marketed in Member States other than the Italian Republic, constitutes a measure having equivalent effect to quantitative restrictions on imports within the meaning of [Article 34 TFEU], unless it can be justified objectively" (§ 58). The case of *Mickelsson and Roos* concerned Swedish restrictions on areas where jet skis could be used. The ECJ held that "where the national regulations for the designation of navigable waters and waterways have the effect of preventing users of personal watercraft from using them for the specific and inherent purposes for which they were intended or of greatly restricting their use, which is for the national court to ascertain, such regulations have the effect of hindering the access to the domestic market in question for those goods and therefore constitute, save where there is a justification pursuant to [Article 36 TFEU] or there are overriding public interest requirements, measures having equivalent effect to quantitative restrictions on imports prohibited by [Article 34 TFEU]."[609]

Free movement of persons, services and capital: direct effect on market access decisive?

In the above-discussed case of *Commission v. Denmark*[610] the ECJ did not use the *Keck* language in a free movement of workers case, but rather stated that "legislation which relates to the conditions in which an economic activity is pursued may constitute an obstacle to freedom of movement". In other cases, the ECJ focused on the *directness* of a hindrance. The case of *Alpine Investments* involved a Dutch regulation prohibiting financial market operators established in the Netherlands from using the telephone, and in particular 'cold calling', to contact potential customers, either inside or outside the

607 Snell 2010, p 449.
608 Case C-110/05 *Commission v. Italy (trailers)*; Snell 2010, p 455.
609 Case C-142/05 *Mickelsson and Roos*, § 28.
610 Case C-464/02 *Commission v. Denmark*.

Netherlands. The ECJ held that although a prohibition such as the one at issue is general and non-discriminatory and neither its object nor its effect is to put the national market at an advantage over providers of services from other Member States, it can none the less constitute a restriction on the freedom to provide cross-border services. Indeed, such a prohibition deprives the operators concerned of a rapid and direct technique for marketing and for contacting potential clients in other Member States. It can therefore constitute a restriction on the freedom to provide cross-border services.[611] Similar restrictions as a result of the prohibition of a certain economic activity in the form acknowledged under the free movement provisions were at issue in *Bosman*,[612] *SETTG*,[613] *Zenatti*[614] and *Torfaen*.[615] In *Graf* the ECJ considered a certain rule to be *too indirect* and too remotely connected to free movement to be tested against its provisions.[616] The case related to the compatibility with EU law of national measures that potentially impeded the decision of a worker to leave one job in order to accept another, possibly in a different Member State, because they provided that in such cases the worker was not entitled to compensation on termination of employment, thus reducing the economic attractiveness of the transfer.[617] The ECJ rejected the argument that such a measure was an obstacle to the freedom of movement of persons within the internal market. Recalling *Alpine*, it stated the principle that provisions which, even if they are applicable without distinction, preclude or deter a national of a Member State from exercising his right to freedom of movement constitute a restriction on that freedom, which is prohibited as a matter of principle by the TFEU, only if they affect access of workers to the labour market. This does not happen, however, if the restrictive effect depends on an event that is *too uncertain and indirect*.[618] Barnard concludes from *Graf* that measures which do not *substantially* hinder access to the market, but merely *structure the market*, fall outside Article 45 TFEU in much the same way as certain selling arrangement cases which do not substantially hinder access to the market fall outside Article 34 TFEU under *Keck*.[619] Advocate General Kokott interprets the concept of an obstacle to market access broadly to include not only measures that 'prevent' but also those that 'significantly impede' access to the market.[620] AG Tizzano welcomed the judgment in *Graf* by pointing out in *CaixaBank* that the provisions on establishment did not grant the Union general powers to regulate economic activities as a self-employed person.[621] On the contrary, they left in place the State powers in that regard, merely prohibiting discrimination and obstacles to establishment and creating defined powers to harmonise national legislation (§ 60). Hence, where such harmonisation has not taken place, the Member States remain

611 Case C-384/93 *Alpine Investments*, § 28 and 35.
612 Case C-415/93 *Bosman*.
613 Case C-398/95 *SETTG*.
614 Case C-67/98 *Zenatti*.
615 Case C-145/88 *Torfaen*.
616 Case C-190/98 *Graf*.
617 Summary by AG Tizzano in case C-442/02 *CaixaBank France*, § 55.
618 AG Tizzano in case C-442/04 *CaixaBank France*, § 56.
619 Barnard 2010, p 245.
620 Opinion AG Kokott in Case C-142/05 *Mickelsson and Roos*, footnote 31; AG Mengozzi concurs with this view in his Opinion in Case C-244/06 *Dynamic Medien*, footnote 32.
621 Opinion AG Tizzano in Case C-442/02 *CaixaBank*.

as a matter of principle competent to regulate the pursuit of economic activities, by means of non-discriminatory measures (§ 61). Another interpretation "would permit economic operators – both national and foreign – to abuse [Article 49 TFEU] in order to oppose any national measure that, solely because it regulated the conditions for pursuing an economic activity, could in the final analysis narrow profit margins and hence reduce the attractiveness of pursuing that particular economic activity" (§ 62). This lead AG Tizzano to the view "that *where the principle of non-discrimination is respected* – and hence the conditions for the *taking-up and pursuit* of an economic activity are equal both *in law and in fact* – a national measure cannot be described as a restriction on the freedom of movement of persons unless, in the light of its purpose and effects, the measure in question *directly affects market access*" (§ 66).

According to Snell, this criterion of directness has at least five disadvantages. First, directness is a matter of degree and therefore uncertain in its reach. Second, directness is a formal matter. Third, the normative justification for accepting indirect impediments is highly unclear, especially in situations where their impact may be considerably higher than rules which do meet the criterion of directness. Fourth, the criterion of directness is at odds with the very starting point of free movement case law, namely *Dassonville*[622] where the ECJ held that both direct and indirect hindrances are caught by the free movement provisions. Fifth, the criterion of directness has been tested to death by the US Supreme Court under the dormant commerce clause of the US Constitution.[623]

Free movement of persons, services and capital: substantial effect on market access decisive?
Having regard to the aforementioned criticism, it is not surprising that there is also ECJ case law which seems to focus more on the question of where a national measure has a *substantial* or *significant*[624] effect on market access. Rules which actually *make* the market were at issue in *Deliège*. Ms. Deliège was a successful Belgian judo player who complained that the Belgian judo federation had not selected her for various international tournaments, thus negatively influencing her sports career. The ECJ held that although selection rules inevitably have the effect of limiting the number of participants in a tournament, such a limitation is inherent in the conduct of an international high-level sports event. Such rules may not therefore in themselves be regarded as constituting a restriction on the freedom to provide services. Although a selection system may prove more favourable to one category of athletes than another, it cannot be inferred from that fact alone that the adoption of that system constitutes a restriction on the freedom to provide services.[625] Barnard has explained this judgment by pointing out that without any rules there would have been no competition.[626] The case of *Deliège* shows that a regulatory system as such does not constitute a *prima facie* restriction on free movement.

622 Case 8/74 *Dassonville*.
623 Snell, p 452-454.
624 Opinion AG Kokott in Case C-142/05 *Mickelsson and Roos*, footnote 31.
625 Joined Cases C-51/96 and C-191/97 *Deliège*, § 64-66.
626 Barnard 2010, p 245.

Disadvantages within such a system may however substantially affect access to that market. *CaixaBank* is an example. French national law prohibited banks established in France to pay remuneration on sight accounts. The prohibition applied to accounts in euros opened by residents of France, whatever their nationality. Caixa-Bank France (Caixa-Bank), a French subsidiary of the Spanish-based Caixa Holding, marketed in France a sight account remunerated at the rate of 2% per annum. By decision of the French authorities Caixa-Bank was prohibited from concluding new contracts with residents of France relating to remunerated sight accounts in euros. In addition, it was ordered to rescind the clauses in existing contracts which provided for the remuneration of such accounts. The ECJ held that a prohibition on the remuneration of sight accounts constitutes, for companies from Member States other than the French Republic, a serious obstacle to the pursuit of their activities via a subsidiary in the latter Member State, affecting their access to the market. That prohibition is therefore to be regarded as a restriction on freedom of establishment. After all, it hinders credit institutions which are subsidiaries of foreign companies in raising capital from the public, by depriving them of the possibility of competing more effectively, by paying remuneration on sight accounts (one of the most effective means), with the credit institutions traditionally established in the Member State of establishment, which have an extensive network of branches and therefore greater opportunities than those subsidiaries for raising capital from the public.[627] It should be emphasized that this prohibition affects equally all companies, domestic and foreign, which want to start banking activities on the French market. It is therefore a truly non-discriminatory prohibition which substantially affected market access.

CaixaBank was confirmed by the ECJ in *Attanasio*. This case concerned Italian regional legislation laying down mandatory minimum distances between roadside service stations. The ECJ held that "a rule such as that at issue in the main proceedings, which makes the opening of new roadside service stations subject to the compliance with minimum distances between service stations, constitutes a restriction within the meaning of Article 49 TFEU. Such a rule, which applies only to new service stations and not to service stations already in existence before the entry into force of the rule, makes access to the activity of fuel distribution subject to conditions and, by being more advantageous to operators who are already present on the Italian market, is liable to deter, or even prevent, access to the Italian market by operators from other Member States." [628]

Commission v. United Kingdom regarded the UK's special share in the company British Airports Authority (BAA).[629] This special share prevented any person from acquiring or being interested in BAA shares carrying the right to more than 15% of the votes. In addition, the national authorities' prior approval was required for certain important decisions of the company. The ECJ held that "although the relevant restrictions on investment operations apply without distinction to both residents and non-residents, it must none the less be held that they affect the position of a person acquiring a shareholding as such and are thus liable to deter investors from other Member States from making such investments and,

[627] Case C-442/02, *Caixa-Bank France*, § 11-14. Compare also Case 286/81 *Oosthoek*, § 15. See for this and other cases Barnard 2010, p 119 *et seq*.

[628] Case C-384/08 *Attanasio,* § 45.

[629] Case C-98/01 *Commission v. United Kingdom*.

consequently, affect access to the market" (§ 47). The ECJ found it relevant to consider that "[t]he restrictions at issue do not arise as the result of the normal operation of company law" (§ 48). Consequently, the rules at issue constituted a restriction on the movement of capital.

Commission v. Italy (motor insurance) concerned an Italian rule which interfered with the freedom to contract.[630] Italian law imposed on insurance companies the obligation to provide third-party liability motor insurance at the request of any potential customer, under terms and rates which the company had to publish in advance. When calculating their premium rates, the insurance companies were subject to certain limitations. The ECJ held:

> "66. (…) the imposition by a Member State of an obligation to contract such as that at issue constitutes a substantial interference in the freedom to contract which economic operators, in principle, enjoy.
> 67. In a sector like that of insurance, such a measure affects the relevant operators' access to the market, in particular where it subjects insurance undertakings not only to an obligation to cover any risks which are proposed to them, but also to requirements to moderate premium rates.
> 68. Inasmuch as it obliges insurance undertakings which enter the Italian market to accept every potential customer, that obligation to contract is likely to lead, in terms of organisation and investment, to significant additional costs for such undertakings.
> 69. If they wish to enter the Italian market under conditions which comply with Italian legislation, such undertakings will be required to re-think their business policy and strategy, *inter alia*, by considerably expanding the range of insurance services offered.
> 70. Inasmuch as it involves changes and costs on such a scale for those undertakings, the obligation to contract renders access to the Italian market less attractive and, if they obtain access to that market, reduces the ability of the undertakings concerned to compete effectively, from the outset, against undertakings traditionally established in Italy (see, to that effect, *CaixaBank France*, paragraphs 13 and 14).
> 71. Therefore, the obligation to contract restricts the freedom of establishment and the freedom to provide services."

Therefore, 'substantial' interferences with the principle of free movement which affect access to the market seem to amount to *prima facie* restrictions which need justification. In other cases, however, the ECJ does not employ a 'substantiality' test at all. We will now discuss some of these cases.

Free movement of persons, services and capital: effect on market access not decisive at all?
In the above-discussed case of *Commission v. Denmark*[631] the ECJ did not find it necessary to say anything about the degree to which market access was affected. It just stated that

630 Case C-518/06 *Commmission v. Italy (motor insurance)*.
631 Case C-464/02 *Commission v. Denmark*.

"legislation which relates to the conditions in which an economic activity is pursued may constitute an obstacle to freedom of movement". This approach is also present in other cases. The case of *Carpenter* is a good example. Mrs. Carpenter, a national of the Philippines, was given leave to enter the United Kingdom as a visitor for six months. She overstayed that leave and failed to apply for any extension of her stay. Later she married Peter Carpenter, a United Kingdom national. A significant proportion of Mr. Carpenter's business consists of providing services, for remuneration, to advertisers established in other Member States. Mrs. Carpenter applied to the Secretary of State for leave to remain in the UK as the spouse of a national of that Member State. Her application was refused, which decision was accompanied by a deportation order. Mrs. Carpenter argued that her deportation would restrict her husband's right to provide and receive services. The ECJ observed in a remarkable reasoning that Mr. Carpenter is exercising the right freely to provide services guaranteed by Article 56 TFEU. The separation of Mr. and Mrs. Carpenter would be detrimental to their family life and, therefore, to the conditions under which Mr. Carpenter exercises a fundamental freedom. As a consequence, Article 56 TFEU was *prima facie* infringed.[632] Thus, the ECJ presented the disruption of family life as an obstacle to the freedom to provide services.[633]

A similar approach for the host State was followed in *Metock*.[634] The ECJ considered that "if Union citizens were not allowed to lead a normal family life in the host Member State, the exercise of the freedoms they are guaranteed by the Treaty would be seriously obstructed" (§ 62). "The refusal of the host Member State to grant rights of entry and residence to the family members of a Union citizen is such as to discourage that citizen from moving to or residing in that Member State, even if his family members are not already lawfully resident in the territory of another Member State" (§ 64).

The ECJ has confirmed the *Carpenter* and *Metock* approaches in *Karner*. This case concerned two Austrian companies, Karner and Troostwijk, which are both engaged in the sale by auction of industrial goods and the purchase of the stock of insolvent companies. In 2001, Troostwijk acquired, with the authorization of the insolvency court, the stock of an insolvent construction company. Karner had also indicated its interest in the purchase of those goods. Troostwijk intended to sell the stock from the insolvent estate in an auction sale. It advertised the auction in a sales catalogue, stating that it was an insolvency auction and that the goods were from the insolvent estate of the company in question. The advertising notice was also posted on the internet. In Karner's view, however, Troostwijk's advertising ran contrary to an Austrian law on consumer protection because it gave the public the impression that it was the insolvency administrator who was selling the insolvent company's assets. In the legal proceedings which followed, the Austrian Supreme Court decided to refer the case to the ECJ. In the first place, the ECJ examined whether the Austrian rule, which prohibits any reference to the fact that the goods in question come from an insolvent estate where, in public announcements or notices intended for

[632] Case C-60/00 *Carpenter*, § 37-39. See for an extensive discussion on the application of general principles of EU law in cross-border situations Douma 2008. Compare also Groussot 2006, p 271 *et seq*.

[633] Hofstötter 2005, p. 551.

[634] Case C-127/08 *Metock*.

a large circle of persons, notice is given of the sale of goods which originate from, but no longer constitute part of the insolvent estate, falls within the scope of application of Article 34 TFEU.[635] The ECJ recalled that all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Union trade are to be regarded as measures having an effect equivalent to quantitative restrictions and thus prohibited by Article 34 TFEU (Case 8/74 *Dassonville*).[636] However, "national provisions restricting or prohibiting certain selling arrangements which apply to all relevant traders operating within the national territory and affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States are not such as to hinder directly or indirectly, actually or potentially, trade between Member States (Joined cases C-267/91 and C-268/91 *Keck and Mithouard*)." The ECJ then applied these principles to the Austrian rule in question. It held that the Austrian rule does not relate to the conditions which those goods must satisfy, but rather governs the marketing of those goods. Accordingly, it must be regarded as concerning selling arrangements within the meaning of *Keck and Mithouard*. Further, the Austrian rule applies to all relevant traders operating within the national territory and affects in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States. Accordingly, the Austrian provision was not caught by the prohibition in Article 34 TFEU.[637] In the second place, the ECJ considered Troostwijk's arguments that the Austrian provision is incompatible with the principle of freedom of expression as laid down in Article 10 ECHR[638]. In that regard, the ECJ recalled that fundamental rights form an integral part of the general principles of law, the observance of which the Court ensures where national legislation falls within the field of application of EU law.[639] The ECJ then examined whether the Austrian legislation is compatible with freedom of expression (conclusion: yes). The case of *Karner* shows that the ECJ is prepared to review national legislation for compatibility with human rights as general principles of EU law, even if that legislation as such does not constitute a restriction on free movement. Indeed, as Hofstötter has stated, the violation of a human right (a general principle of EU law) may cause a restriction on free movement even in the absence of any discriminatory treatment of cross-border economic activity.[640]

The above-mentioned cases are not the only examples of ECJ case law which ignores the market access criterion. The *Volkswagen* case concerned an action for failure to fulfil obligations brought in relation to certain paragraphs of the Volkswagen Law. Specifically, the Commission complained about the limitation of voting rights to 20% of the share capital where a shareholder holds in excess of that amount and the fact that the majority required to adopt resolutions is increased to more than 80%, whereas the generally applicable *Aktiengesetz* (German Law on public limited companies) provides for a majority

635 Case C-71/02 *Karner*, § 35.
636 Case C-71/02 *Karner*, § 36.
637 Case C-71/02 *Karner*, § 43.
638 European Convention for the Protection of Human Rights and Fundamental Freedoms signed in Rome on 4 November 1950.
639 Case C-71/02 *Karner*, § 48-49.
640 The ECJ has confirmed this approach in Case C-71/02 *Karner*.

of 75%.[641] The ECJ held that these measures constitute restrictions on free movement of capital:

> "46. This requirement, derogating from general law, and imposed by way of specific legislation, thus affords any shareholder holding 20% of the share capital a blocking minority.
> 47. Admittedly, as the Federal Republic of Germany has stated, this power applies without distinction. In the same way as the cap on voting rights, it may operate both to the benefit and to the detriment of any shareholder in the company.
> 48. However, it is apparent from the file that, when the VW Law was adopted in 1960, the Federal State and the Land of Lower Saxony were the two main shareholders in Volkswagen, a recently privatized company, and each held 20% of its capital.
> 49. According to the information provided to the Court, while the Federal State has chosen to part with its interest in the capital of Volkswagen, the Land of Lower Saxony, for its part, still retains an interest in the region of 20 %.
> 50. Paragraph 4(3) of the VW Law thus creates an instrument enabling the Federal and State authorities to procure for themselves a blocking minority allowing them to oppose important resolutions, on the basis of a lower level of investment than would be required under general company law.
> 51. By capping voting rights at the same level of 20%, Paragraph 2(1) of the VW Law supplements a legal framework which enables the Federal and State authorities to exercise considerable influence on the basis of such a reduced investment.
> 52. By limiting the possibility for other shareholders to participate in the company with a view to establishing or maintaining lasting and direct economic links with it which would make possible effective participation in the management of that company or in its control, this situation is liable to deter direct investors from other Member States."[642]

This approach of comparison between the 'normal' structure of company law and derogations thereof may give a more precise meaning to the notion of a 'substantial' effect on free movement.

The case of *Commission v. France* (*performing artists*) also hints in this direction. This case concerned, *inter alia*, a French rule which laid down a presumption of salaried status for certain artists. The ECJ held that this rule, which applied to both domestic and foreign artists, infringed the freedom to provide services:

> "the presumption of salaried status at issue, irrespective of whether it is more or less difficult to rebut, constitutes a restriction on freedom to provide services within the meaning of [Article 56 TFEU]. Even if it does *not deprive*, in the true meaning of the word, the performing artists in question of the opportunity to pursue their activities in France in a self-employed capacity, it none the less places them at a *disadvantage* that may impede their activities as service providers. In order to avoid

[641] Summary by AG Ruiz-Jarabo Colomer in his Opinion is the *Volkswagen* case, § 4.
[642] Case C-112/05 *Commission v. Germany* (Volkswagen).

> their contract being accorded the status of employment contract, which would entail *additional costs* because of the obligation, in France, to pay contributions as affiliates of the social security scheme for employed persons, and bring them under the scheme for annual paid leave, they must prove that they do not work as employees but, on the contrary, are self-employed. Thus, the presumption of salaried status at issue is likely both to discourage the artists in question from providing their services in France and discourage French organizers of events from engaging such artists."[643]

Thus, truly non-discriminatory rules which place competitors at a disadvantage (additional costs) may thus constitute a *prima facie* restriction on free movement. The nature of the concept of 'disadvantage' implies a comparison with a 'normal' situation: it is a relative concept. In the case of *performing artists* the disadvantage is probably arrived at through a comparison with self-employed persons who do not fall on the legal presumption in question.

Commission v. Netherlands concerned the golden shares of the Netherlands State in respect of TPG and KPN.[644] By virtue of these special shares, a series of very important management decisions of the organs of KPN and TPG, concerning both the activities of those two companies and their very structure (in particular questions of merger, demerger and dissolution), depend on prior approval by the Netherlands State. The ECJ considered:

> "24. (…) Thus, in the first place, as the Commission has rightly pointed out, those special shares confer on the Netherlands State an influence over the management of KPN and TPG which is not justified by the size of its investment and is significantly greater than that which its ordinary shareholding in those companies would normally allow it to obtain. Moreover, those shares limit the influence of other shareholders in relation to the size of their holding in KPN and TPG.
> 25. Furthermore, those special shares can be withdrawn only with the consent of the Netherlands State.
> 26. By making decisions of such importance subject to the prior approval of the Netherlands State and thereby limiting the possibility of other shareholders participating effectively in the management of the company concerned, the existence of those shares may have a negative influence on direct investments.
> 27. Similarly, the special shares at issue may have a deterrent effect on portfolio investments in KPN and TPG. A possible refusal by the Netherlands State to approve an important decision, proposed by the organs of the company concerned as being in the company's interests, would be capable of depressing the (stock market) value of the shares of that company and thus reduces the attractiveness of an investment in such shares."

643 Case C-255/04 *Commission v. France*, § 38. Italics by the author.
644 Joined Cases C-282/04 and C-283/04 *Commission v. Netherlands (Golden shares)*.

Since those restrictive effects were not too uncertain or too indirect to constitute an obstacle to the free movement of capital, the ECJ held that the special shares constitute restrictions within the meaning of Article 63(1) TFEU. The ECJ significantly extended the scope of free movement of capital by indicating that measures which may depress the stock value of shares in a company constitute a *prima facie* restriction of Article 63(1) TFEU: any interference with economic freedom is likely to depress the share prices in some companies.[645]

The last case I would like to discuss is *Government of the French Community and Walloon Government*.[646] This case concerned the Flemish compulsory care insurance scheme which was open to persons working in the Flemish region of Belgium, provided that they also resided in that region or in another EU Member State. The scheme was, therefore, not open for EU citizens working in the Flemish region but residing in another part of Belgium. The ECJ reiterated that Articles 45 and 49 TFEU militate against any national measure which, even though applicable without discrimination on grounds of nationality, is capable of hindering or rendering less attractive the exercise by EU nationals of the fundamental freedoms guaranteed by the Treaty (§ 45). The Flemish legislation is such as to produce those restrictive effects, inasmuch as it makes affiliation to the care insurance scheme dependent on the condition of residence in either a limited part of national territory or in another Member State (§ 47). Migrant workers, pursuing or contemplating the pursuit of employment or self-employment in Flanders, might be dissuaded from making use of their freedom of movement and from leaving their Member State of origin to stay in Belgium, by reason of the fact that moving to certain parts of Belgium would cause them to lose the opportunity of eligibility for the benefits which they might otherwise have claimed. In other words, the fact that employed or self-employed workers find themselves in a situation in which they suffer either the loss of eligibility to care insurance or a limitation of the place to which they transfer their residence is, at the very least, capable of impeding the exercise of the rights conferred by Articles 45 and 49 TFEU (§ 48). For a measure to restrict freedom of movement, it is enough that the measure should benefit, as in the case of the care insurance scheme, certain categories of persons pursuing occupational activity in the Member State in question (§ 50). The restrictive effects of the Flemish legislation are not to be considered too indirect and uncertain for it to be impossible to regard that legislation as constituting an obstacle contrary to Articles 45 and 49 TFEU. In particular, unlike the case giving rise to the judgment in Case C−190/98 *Graf*, possible entitlement to the insurance care benefits at issue depends, not on a future and hypothetical event for the employed or self-employed worker concerned, but on a circumstance linked, *ex hypothesi*, to the exercise of the right to freedom of movement, namely, the choice of transfer of residence (§ 51). Moreover, any restriction of free movement, even minor, of that freedom is *prima facie* prohibited (§ 52). It followed that the Flemish legislation entails an obstacle to freedom of movement for workers and to freedom of establishment. Again, the ECJ did not employ a market access test, using terms such as "dissuade".[647]

645 See Snell 2010, p 463.
646 Case C-212/06 *Government of the French Community and Walloon Government*.
647 Snell 2010, p 464.

Towards a third way between anti-protectionism and economic freedom?

The above-discussed case law on the question of under what circumstances a non-discriminatory measure amounts to a restriction on free movement is multicoloured. Some case law focuses on either the direct or substantial impact of a measure on market access, whereas other case law does not mention the market access at all but focuses instead on the question of whether the measure makes free movement less attractive. According to Snell, it is not surprising that the market access criterion has proved difficult to define.[648] First, when pressed, the notion may collapse into economic freedom. "[A]ll limitations to economic freedom have more or less significant effects on market access, depending ultimately on the impact on profits on the facts. If the law were to prohibit each and every hindrance to market access, it would as a matter of logic have to ban all rules limiting the commercial freedom of traders."[649] Second, the notion of market access may also collapse into anti-protectionism. "Any measure which reduces the ability of or incentives for new operators to enter a market will protect the position of the established operators."[650] Snell suspects that the notion of market access is used to conceal the need to choose between these two competing paradigms of free movement law. If this is indeed true, the notion cannot be used as a 'third way' between anti-protectionism and economic freedom.[651]

In my view, the dilemma discussed by Snell can be solved by application of the theoretical optimization model. This model takes economic freedom as a starting point in phase 1 (the 'disadvantage' test; section 7.3.1): every national measure which – in Snell's terminology – has a negative effect on profits *prima facie* infringes free movement. The second phase of the model implements an important correction on this very wide disadvantage test: the principle of free movement should accept that it may be limited by the principle of sovereignty and the national measures implemented under its wing. This means that the principle of free movement cannot be interpreted in a way by which regulation *as such* would ultimately be prohibited (compare section 7.4.2). The starting point is that Member States are – in the exercise of their sovereignty – competent to organize their regulatory systems; the principle of free movement cannot implement any law-making of its own which would be 'better' (compare section 7.4.4). The principle of free movement is, however, capable of optimizing these regulatory systems by application of the tests of suitability, degree of fit, subsidiarity and proportionality in its narrow sense (phases 3, 4, 5 and 6 of the model). If this is taken into account, a middle ground between anti-protectionism and economic freedom is ultimately achieved.

A number of the cases discussed above illustrate this. *Keck*'s distinction between product requirements and selling arrangements can be explained by accepting that the national measures in both situations lead to a disadvantage – a *prima facie* restriction on free movement of goods – within the meaning of phase 1 of the theoretical optimization model. Subsequently, one should observe that respectful aims are pursued by both product requirements and selling arrangements (phase 2 of the model): e.g. consumer protection and the achievement of a level playing field for the marketing of products in the Member

[648] Snell 2010, p 467.
[649] Snell 2010, p 468.
[650] Snell 2010, p 468.
[651] Snell 2010, p 471.

State concerned. Both categories are suitable to achieve their objective (phase 3 of the model). If phases 4 and 5 of the model are applied, however, one will observe that national measures which impose product requirements are often overinclusive in relation to their objective or that alternative measures are available which are less burdensome for the free movement of goods but which achieve the same objective (e.g. health checks may already have been performed in the Member State of origin of the product or certain information for consumers may easily be made available by an additional sticker on the product). In such a case, the model is able to optimize the national measures which impose product requirements against the free movement of goods. This is often not possible in relation to selling arrangements. For instance, the objectives pursued by these national measures cannot be achieved by similar rules in another Member State, as a result of which they are not overinclusive. Also, alternative measures which are able to achieve the same objective will not be easily available. Thus, the theoretical optimization model is able to explain the *Keck* doctrine and the subsequent developments in that area. A major advantage of this approach is that the notions of 'product requirements' and 'selling arrangements' do not become autonomous objects of legal interpretation. In *Volkswagen*, the ECJ decided that the derogation in the Volkswagen Law from the 'normal' structure of the German company law constituted a *prima facie* restriction on free movement of capital.[652] Thus, the power to introduce rules on company law was duly respected. Only the derogations – which imposed specific disadvantages – were subject to scrutiny. The case of *Commission v. France* (*performing artists*) is another example.[653] In that case, the disadvantage was probably arrived at through a comparison with self-employed persons who do not fall on the legal presumption in question. Thus, the power to regulate was duly respected and only the derogation which imposed a specific disadvantage was subject to proportionality analysis. *Commission v. Netherlands* concerned the golden shares of the Netherlands State in respect of TPG and KPN.[654] The ECJ held that these *special* shares constituted restrictions within the meaning of Article 63(1) TFEU, because they may depress the stock value of shares in a company. Again, the ECJ emphasized that the disadvantageous effect at issue was caused not by the regulatory system as such, but by a derogation thereof. The last example is *Government of the French Community and Walloon Government*.[655] This case concerned the Flemish compulsory care insurance scheme which was open for persons working the Flemish region of Belgium, provided that they also reside in that region or in another EU Member State. The ECJ considered that, for a measure to restrict freedom of movement, it is enough that the measure should benefit *certain categories* of persons exercising their free movement rights. Again, emphasis was put on the derogations in a regulatory system which impose specific disadvantages. If free movement law is phrased in such a way, both the objectives of anti-protectionism and economic freedom are achieved, without any extreme outcomes, in line with the theoretical optimization model.

652 Case C-112/05 *Commission v. Germany* (Volkswagen).
653 Case C-255/04 *Commission v. France*, § 38. Italics by the author.
654 Joined Cases C-282/04 and C-283/04 *Commission v. Netherlands (Golden shares)*.
655 Case C-212/06 *Government of the French Community and Walloon Government*.

Concluding remarks and examples

It may be inferred from the above-discussed non-tax case law that *prima facie* restrictions of free movement may be caused not only by tax rules which discriminate, legally or factually, against cross-border economic activity, but also by tax rules which otherwise prohibit, impede or render less attractive the exercise of free movement rights. It should, therefore, be expected that future ECJ case law in the field of direct taxation will also cover non-discriminatory direct tax measures, without ultimately prohibiting taxation *as such*, in the same manner as just described. Two examples may illustrate the practical relevance of this finding.

The first example is a Dutch anti-abuse provision which applies to the same extent to domestic and cross-border situations and concerns the carry-over of losses upon a substantial change in ownership of the company concerned. Losses incurred by a company may generally only be carried forward if at least 70% of its shares continue to be held by the same individual shareholders. If a company reduces its business by more than 70% and less than 70% of its shares continue to be held by the same shareholder(s), losses that have not been offset may only be set off against future profits arising from the original business activities. This change of control rule leads to an identifiable 'disadvantage' (in relation to the situation applicable without that measure) and therefore to a *prima facie* restriction on freedom of establishment. According to settled ECJ case law, a restriction on the freedom of establishment is permissible only if it is justified by overriding reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective in question and not go beyond what is necessary to attain it. The objective of the Dutch change of ownership rules is to counter the trade in companies with tax losses. This is considered to be abusive in situations where the acquisition of the activities or organisation of a loss company is not the central reason for the acquisition of the shares in that company, but rather the possibility to obtain a tax advantage.[656] A company could acquire the shares in a loss company with the aim of starting a new profitable business in that company. Without any anti-abuse legislation, these profits would not be taxable due to loss carry-forward. This may not only result in a disadvantage for the treasury, but also in competitive disadvantage for similar businesses, the profits of which would be taxable.[657] According to settled ECJ case law, the prevention of tax evasion can be accepted as justification only if the legislation is aimed at wholly artificial arrangements the objective of which is to circumvent the tax laws, which precludes any general presumption of tax evasion. Consequently, a general presumption of tax avoidance or tax evasion cannot justify a fiscal measure which compromises the objectives of the TFEU.[658] In my view, it is clear that the Dutch change of ownership rules lay down such a general presumption of tax avoidance. This presumption goes beyond what is necessary to attain the objective of the prevention of tax avoidance. As a consequence, the possible restriction on freedom of establishment imposed by these rules can be upheld only in true cases of tax avoidance.

656 Kamerstukken II 1999/2000, 27 209, nr. 7, p. 15.
657 Kamerstukken II 1999/2000, 27 209, nr. 3, p. 11.
658 Case C-451/05 *ELISA*, § 91.

A second example of an anti-abuse provision which applies to the same extent to domestic and cross-border situations concerns the Dutch thin capitalization provisions. Under these provisions, the deduction of interest on intra-group loans may be restricted if a taxpayer is deemed to have an inadequate amount of equity compared with his amount of debt. The restriction of interest deduction is limited to cases where there is a group of affiliated companies. Under the 'disadvantage' test, this thin capitalization rule constitutes a *prima facie* restriction on freedom of establishment. It is settled ECJ case law that a restriction on the freedom of establishment is permissible only if it is justified by overriding reasons in the public interest. It is further necessary that its application be appropriate to ensuring the attainment of the objective in question and not go beyond what is necessary to attain it. Thin capitalization rules are aimed at the prevention of artificial shifts of the taxable basis in groups of companies and at the prevention of the erosion of the Dutch tax base through the allocation of deductible interest costs.[659] *Test Claimants in the Thin Cap Group Litigation* concerned the UK thin capitalisation legislation which had a similar objective. The ECJ considered that thin capitalization rules should not be applied insofar as the interest payment reflects at arm's length relations. Moreover, the taxpayer should be able to provide a commercial justification for the interest payment.[660]

8.3 The requirement of a respectful aim

8.3.1 Current ECJ case law on direct taxation

8.3.1.1 Introduction

If a certain 'disadvantage' has been identified, the next step of the theoretical optimization model requires that the tax measure which leads to this disadvantage has a 'respectful aim' and that the EU free movement provision which affects this tax measure is also respectful towards the principle of tax sovereignty. This is the idea of a 'twofold neutrality' (section 7.4.1). ECJ case law in the area of direct taxation states that a restriction on free movement can be justified if either an express Treaty derogation applies or the tax measure at issue pursues a 'legitimate objective which is compatible with EU law' and is 'justified by overriding reasons in the public interest'. This section discusses ECJ case law which illustrates this justification analysis.

8.3.1.2 Aim determination and plurality of objectives

Introduction
It has been discussed in section 4.5.2 that it may difficult, first, to determine the aim of a national measure and, second, to deal with a plurality of objectives. The case of *Finalarte*, albeit not a tax case, will be discussed to illustrate the first problem. The cases of *Campus oil* and *Nertsvoederfabriek Nederland* serve as an illustration to the second problem.

[659] Kamerstukken II 2003/04, 29 210, nr. 8, p 9, and Kamerstukken II 2003/04, 29 210, nr. 8, p 10.
[660] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, § 73-83.

Finalarte

This judgment concerned the German scheme of paid leave for workers in the construction industry.[661] In this industry, workers change employers frequently. For that reason, German law provides that the various employment relationships entered into by the worker during the reference year are to be treated as if they were a single employment relationship. This fiction enables the worker to accumulate holiday entitlement acquired with different employers in the course of the reference year and to claim that full entitlement from his current employer, irrespective of the duration of the employment relationship with that employer. The ordinary consequence of that system would be to impose a heavy financial burden on the current employer because he is required to pay the worker holiday pay even for holiday acquired with other employers. A fund was established in order to overcome this drawback and to ensure an equitable distribution of the financial burden between the employers concerned. To this end, employers established in Germany pay contributions to the fund amounting to 14.45% of their total gross wages. In return the employers are entitled, *inter alia*, to full or partial reimbursement of the benefits paid to workers in respect of holiday pay and additional holiday allowance. German law also applies the obligation to contribute to the fund to employment relationships between undertakings whose registered office is situated outside Germany and workers they send to carry out construction work on sites in Germany. None the less there are differences between the scheme applying to employers established in Germany and that applying to other employers. First, in contrast to the scheme for employers established in Germany, the employer established abroad is not entitled to claim reimbursement from the fund. It is always the posted worker himself who is entitled to receive holiday pay from the fund. Second, employers established outside Germany must disclose more information to the fund than those established in Germany. Third, a foreign employer is always subject to the obligation to contribute to the fund in respect of workers on a German construction site. In a purely German context, however, this obligation applies to the organizational entity from which workers are posted to a construction site.

The ECJ first recalled that freedom to provide services requires not only the elimination of any discrimination on grounds of nationality against providers of services who are established in another Member State but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, which is liable to prohibit, impede or render less advantageous the activities of a provider of services established in another Member State where he lawfully provides similar services.[662] In particular, a Member State may not make the provision of services in its territory subject to compliance with all the conditions required for establishment and thereby deprive the provisions of the Treaty whose object is, precisely, to guarantee the freedom to provide services, of all practical effect. In that regard, the application of the host Member State's national rules to providers of services is liable to prohibit, impede or render less attractive the provision of services to the extent that it involves expense

[661] Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*. The following account of German law and the facts is derived from § 3-14.

[662] Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*, § 28.

and additional administrative and economic burdens. The application of the obligation to participate in the fund to providers of services established outside Germany has the effect of increasing their costs and administrative and economic burdens, which implies a restriction of the freedom to provide services.[663]

Next the ECJ reiterated that such a restriction of the freedom to provide services is justifiable only if it is necessary in order to pursue, effectively and by appropriate means, an objective in the public interest.[664] Here the judgment becomes interesting for the present section of this study. The ECJ observed that the national court had pointed out that it appears from the explanatory memorandum of the German law that the declared aim of that law is to protect German businesses in the construction industry from the increasing pressure of competition in the European internal market, and thus from foreign providers of services. The national court adds that, from the start of discussions on the draft of that law, it had been pointed out on numerous occasions that such a law would, above all, combat the allegedly unfair practice of European businesses engaged in low-pay competition.[665] According to settled case law, however, measures restricting the freedom to provide services cannot be justified by economic aims, such as the protection of national businesses; these aims are not legitimate or, in the terminology of the present study, not 'respectful' towards the principle of free movement.[666] Surprisingly, this was not fatal for the German system:

> "40. However, whilst the intention of the legislature, to be gathered from the political debates preceding the adoption of a law or from the statement of the grounds on which it was adopted, may be an indication of the aim of that law, it is not conclusive.
> 41. It is, on the contrary, for the national court to check whether, viewed objectively, the rules in question in the main proceedings promote the protection of posted workers."

The ECJ subsequently laid out a number of assessments for the national court to make in order to verify whether this criterion is met. For the present study, it is important to note that i) the objective of a restrictive national measure should be determined objectively[667]

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663 Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*, § 35.

664 Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*, § 37.

665 Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*, § 38.

666 Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-68/98 to C-71/98 *Finalarte and Others*, § 39.

667 A similar approach is taken in the area of State aid; compare Case C-487/06 P *British Aggregates Association*, § 82-88. Compare also Case C-521/07 *Commission v. Netherlands*, where the ECJ considered that the non-applicability of Directive 77/799 on information exchange by tax authorities was not the 'real' reason for the application of the dividend withholding tax in question, because the Netherlands apparently did not need any information from foreign tax authorities: in situations involving a higher shareholding percentage the Netherlands did not

– i.e. not only on the basis of its legislative history but also on the basis of its effects[668] – and ii) an illegitimate objective may be 'saved' by an objective which can be regarded as legitimate. This was also the case in *Campus Oil*.

Campus Oil

This case concerned Irish rules requiring petrol importers to purchase part of their requirements from the only oil refinery in Ireland at a fixed price. In the absence of these rules, the Irish oil refinery would go out of business, leaving Ireland without any domestic refining capacity. The ECJ held that this obligation constitutes a *prima facie* restriction of free movement of goods because of its protective effect.[669] In principle, a protective aim cannot be regarded as legitimate, because it denies the existence of free movement. In *Campus Oil*, however, the ECJ arrived at a different conclusion. The relevant considerations justify quotation in full:

> "34. It should be stated (…) that petroleum products because of their exceptional importance as an energy source in the modern economy are of fundamental importance for a country's existence since not only its economy but above all its institutions, its essential public services and even the survival of its inhabitants depend upon them. An interruption of supplies of petroleum products with the resultant dangers for the country's existence, could therefore seriously affect the public security that [Article 36 TFEU] allows States to protect.
> 35. It is true that (…) Article 36 refers to matters of a non-economic nature. A Member State cannot be allowed to avoid the effects of measures provided for in the Treaty by pleading the economic difficulties caused by the elimination of barriers to intra-Community trade. However, in the light of the seriousness of the consequences that an interruption in supplies of petroleum products may have for a country's existence, the aim of ensuring a minimum supply of petroleum products at all times is to be regarded as transcending purely economic considerations and thus as capable of constituting an objective covered by the concept of public security.
> 36. It should be added that to come within the ambit of Article 36, the rules in question must be justified by objective circumstances corresponding to the needs of public security. Once that justification has been established, the fact that the rules

levy any withholding tax on the basis of tax treaties whereas the alleged need for information should have been the same in those cases.

668 Compare in this respect also Case C-169/07 *Hartlauer*, § 55, where the ECJ held that restrictive domestic legislation "is appropriate for ensuring attainment of the objective pursued only if it *genuinely* reflects a concern to attain it in a *consistent* and *systematic* manner". Similarly, in respect of Finnish regulation of games of chance, the ECJ found in Case C-124/97 *Läärä*, § 37, that "the fact that the games in issue are not totally prohibited is not enough to show that the national legislation is *not in reality* intended to achieve the public interest objectives at which it is purportedly aimed, which must be considered as a whole." This shows that the ECJ also looks at the system of the law to verify its purpose. Compare also the Opinion of AG Kokott in Joined Cases C-436/08 and C-437/08 *Haribo and Österreichische Salinen*, § 63-69, §88 and § 98-102.

669 Case 72/83 *Campus Oil*, § 16.

> are of such a nature as to make it possible to achieve, in addition to the objectives covered by the concept of public security, other objectives of an economic nature which the Member State may also seek to achieve, does not exclude the application of Article 36."

Thus, in *Campus Oil*, the ECJ approved of a national measure that had a partially economic purpose – the protection of an Irish oil refinery – because the other objectives of the measure were non-economic.[670] In *Nertsvoederfabriek Nederland* this line of thinking was developed further.

Nertsvoederfabriek Nederland
This case concerned Dutch legislation which obliged producers to deliver poultry offal only to rendering plants licensed by the Dutch authorities. Nertsvoederfabriek Nederland was prosecuted for breaching this law. The ECJ held that Article 35 TFEU (prohibition restrictions on exports) was applicable in this case, because the imposition of an obligation on producers to deliver poultry offal to their local authority implies a prohibition of exports. The Netherlands government argued that this obligation was necessary to prevent the spread of disease and pollution, but the problem was that the obligation also contributed to the profitability of domestic undertakings (which converted the offal into animal food which they sold on the market). In respect of this last aspect, the Dutch government replied that the licensed plants need these profits to pay for their legal duties. The ECJ considered:

> "14. With respect (…) to the obligation to deliver poultry offal only to licensed rendering plants to the exclusion of any other economic operator carrying on business with the national territory, the Netherlands government argued convincingly that that obligation was necessary in order to maintain the overall effectiveness of the system set up by the [national law], with a view to ensuring that all animal waste was removed and disposed of in a manner which providing all the required safeguards for the life and health of humans and animals.
> 15. In those circumstances, it is irrelevant that the poultry offal can, after processing, yield a product which can be marketed by the rendering plants, thus ensuring their profitability. As the Court acknowledged in [Campus Oil], the mere fact that national provisions, justified by objective circumstances corresponding to the needs of the interests referred to therein, enable other objectives of an economic nature to be achieved as well, does not exclude the application of [Article 36 TFEU]. That applies with greater force where the objective of an economic nature necessarily enables the objective relating to health to be attained."

Subsequently, the ECJ found that the objective of health protection could have been achieved by less restrictive means. For purposes of the present study it is important to note that the ECJ has accepted that the achievement of an economic aim might be necessary for

[670] See Snell 2005, p 41-42.

the achievement of a public interest aim. If that is the case, the measure overall pursues a legitimate objective.[671]

8.3.1.3 Directly discriminatory tax rules

The classic four freedoms of the TFEU – free movement of goods, persons, services and capital – all prohibit distinctions which are directly based on the origin of the product or on the (foreign) nationality of the taxpayer concerned. Such distinctions can only be justified on grounds of the express Treaty derogations[672] such as public morality, public policy, public security and public health.[673] This was recognized for direct taxation in case C-311/97 *Royal Bank of Scotland*.[674] This case concerned Greek tax legislation which introduced a difference of treatment in the calculation of tax on the profits of companies, depending on whether they have their seat in Greece or outside that Member State. Two rates of tax were applicable to the profits of companies having their seat in Greece, which, on certain conditions relating to their legal form and the nature of the shares which they issue, may be taxed at the rate of 35% instead of the rate of 40%. The lower rate applies to domestic public limited companies of which the shares are quoted on the Athens Stock Exchange. In order to be able to carry on banking business in Greece, the national legislation on banks requires a company having its seat in Greece to carry on that business in the form of a public limited company and to issue registered shares, so that it thereby escapes application of the rate of tax at 40%. On the other hand, a single rate of tax, the higher one, applies to the profits taxable in Greece of companies having their seat in another Member State, whatever their legal form and the nature of the shares they issue. Consequently, as regards banks, the higher rate of taxation applies only to banks having their seat in another Member State and a permanent establishment in Greece. The ECJ found that this difference in tax rate infringes the freedom of establishment (Article 49 TFEU). The ECJ then examined whether the discrimination may be justified. It held that, according to settled case law, only an express derogating provision, such as Article 52 TFEU, could render such discrimination compatible with EU law. As the Greek Government had not relied on any of these grounds, freedom of establishment was to be interpreted as precluding the tax legislation at issue.[675] This approach can be explained by acknowledging that the lower tax rate could indeed only apply to companies with Greek 'nationality', as a consequence of which the legislation was directly discriminatory.

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671 See Snell 2005, p 42-43. Compare also the Opinion of AG Poiares Maduro in case C-347/*04 Rewe Zentralfinanz*, footnote 34.

672 Express Treaty derogations are laid down in Articles 36, 45(3), 52(1), 62 and 65(1)(b) TFEU. Note that there are no treaty derogations for direct discrimination of goods on grounds of their origin as regards internal taxation of these goods (Article 110 TFEU).

673 Case C-423/98 *Albore*, § 16-17 and Case 2/74 *Reyners*.

674 See also case C-155/09 *Commission v. Greece*, § 69 et seq.

675 C-311/97 *Royal Bank of Scotland*, § 32-34.

8.3.1.4 Other restrictive tax rules: legitimate objective and overriding reasons

Introduction

The rules regarding equality of treatment forbid, however, not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.[676] The criterion of 'residence' which is used by all national tax systems is an example of such a criterion.[677] A direct tax measure which amounts to a *prima facie* restriction on free movement and which does not discriminate directly on grounds of nationality may be allowed only if it pursues a 'legitimate objective which is compatible with EU law' and is 'justified by overriding reasons in the public interest'.[678] This is often referred to as the 'rule of reason'.

Legitimate objective compatible with EU law

This first requirement has been at issue in Case C-39/04 *Laboratoires Fournier*.[679] Under French tax legislation a tax credit, in respect of corporation tax, for research was available solely for research activities carried out in France. Fournier, which manufactures and sells pharmaceuticals, subcontracted to research centres based in various Member States numerous research projects and took the resultant expenditure into account in calculating its tax credit for research for the years 1995 and 1996. The French tax authorities however refused to grant a tax credit in respect of that expenditure. The question arises as to whether this refusal restricts the freedom to provide services (Article 56 TFEU). The ECJ stated that French tax legislation, by restricting the benefit of a tax credit for research only to research carried out in that Member State, makes the provision of services constituted by the research activity subject to different tax arrangements depending on whether it is carried out in other Member States or in the Member State. Such legislation differentiates according to the place where the services are provided, contrary to Article 56 TFEU. The French Government contended, however, that the legislation was justified by the objective of promoting research. The ECJ replied that the promotion of research and development may indeed be an overriding reason relating to public interest. The fact remained however that it could not justify a rule which refuses the benefit of a tax credit for research for any research not carried out in the Member State concerned. "Such legislation is directly contrary to the objective of the Community policy on research and technological development which, according to Article 163(1) EC [now Article 179(1) TFEU] is, *inter alia*, 'strengthening the scientific and technological bases of Community industry and encouraging it to become more competitive at international level'. Article 163(2) EC [now Article 179(2) TFEU] provides in particular that, for this purpose, the Community is to 'support [undertakings'] efforts to cooperate with one another, aiming, notably, at enabling [them] to exploit the internal market potential to the full, in particular

[676] Case 152/73 *Sotgiu*, § 11.

[677] Case C-175/88 *Biehl*, § 14.

[678] E.g. Case C-527/06 *Renneberg*, § 81; Case C-446/03 *Marks & Spencer*, §35; Case C-196/04 *Cadbury Schweppes*, § 47.

[679] Compare also Case C-281/06 *Jundt*, § 60-63; Case C-248/06 *Commission v. Spain*. Compare also Case C-254/*97Société Baxter* and Case C-10/10 *Commission v Austria*.

through … the removal of legal and fiscal obstacles to that cooperation.'" As a result, the objective of the French tax credit was not compatible with the EC Treaty – or, at present, the TFEU – insofar as it was restricted to research activities on French territory.

Overriding reasons in the public interest
A study by Kingston provides an overview of 'accepted', 'accepted in principle but not in practice', and 'rejected' grounds of justification.[680] The list with 'accepted' grounds contains the following reasons:

- the requirements of fiscal cohesion
- the need to counter tax avoidance
- the need to prevent a double use of losses
- the need to ensure effective fiscal supervision and tax collection, and
- the need for a "balanced allocation" of taxing powers between the Member States or the "territoriality" principle.

The following grounds have been accepted in principle, but never in practice (normally due to lack of compliance with the requirement that national measures be proportionate to the justification):

- grounds of public health and the prevention of wrongdoing
- the promotion of research
- the promotion of national culture
- (possibly) the need to protect a constitutional right to accommodation
- objectives connected with the carrying on of the activities of agricultural and forestry holdings
- the preservation of jobs, and
- the need to simplify the tax system.

The list of justifications rejected by the ECJ includes the following grounds:

- budgetary concerns underlying a national measure
- protection of the tax base
- the existence of other tax advantages to compensate for the alleged tax disadvantage
- the need to preserve competitive neutrality between foreign and domestic companies
- the availability of an alternative legal or business form
- the lack of EC harmonization concerning the impugned national tax measure, and
- the fact that the otherwise unlawful treatment is required by a bilateral tax treaty.

680 Kingston 2007, p 1347. See for a comprehensive overview Cordewener, Kofler & Van Thiel 2009. See also Barnard 2010, p 512-516 ("the justifications recognized by the court").

It is useful to illustrate the above by discussing the cases of *Avoir fiscal*, *Manninen*, *Cadbury Schweppes*, *Oy AA* and *Papillon*. These cases typically show how the ECJ deals with grounds of justification and serve as a good basis for comparison with the theoretical optimization model in section 8.3.2.

Avoir fiscal
This case concerned a French tax credit, known as an 'avoir fiscal', which was intended to avoid the economic double taxation of company profits, first in the form of corporation tax, and then through tax levied on beneficiaries of dividends, and which was available only to companies having their seat in France or in the territory of States having concluded with France conventions for the avoidance of double taxation to that effect. French law did not contain a general rule which granted an 'avoir fiscal' to dividends attributable to a French permanent establishment of a foreign company. The European Commission sought to establish that the absence of an 'avoir fiscal' in these cases discriminates against branches and agencies of companies whose registered office is situated in another Member State, in particular with regard to insurance companies because they typically operate through branches rather than subsidiaries. France brought forward various lines of defence to justify this disadvantageous treatment, which were all rejected by the ECJ.

In its first line of argument the French government argued that the difference in question is based on the distinction between 'residents' and 'non-residents', which is to be found in all legal systems and is internationally accepted. Furthermore, branches and agencies of companies whose registered office is abroad enjoy various advantages over French companies which would balance out any disadvantages in regard to shareholders' tax credits. Finally, those disadvantages would in any event be insignificant and could easily have been avoided by setting up a subsidiary in France.

The ECJ held, first, that freedom of establishment would be deprived of all meaning if the proposition were accepted that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State.[681] Second, the ECJ observed that it cannot altogether be excluded that a distinction based on the location of the registered office of a company or the place of residence of a natural person may, under certain conditions, be justified in an area such as tax law. In the present case, however, subsidiaries resident in France and French permanent establishments of a foreign company are treated in the same way for the purposes of taxing their profits. By doing so, the French legislature has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment.[682] Third, the ECJ decided that the difference in treatment also cannot be justified by any advantages which branches and agencies may enjoy vis-à-vis companies and which, according to the French government, balance out the disadvantages resulting from the failure to grant the benefit of shareholders' tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article 49 TFEU to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded

[681] Case 270/83 *Commission v. France (avoir fiscal)*, § 18.
[682] Case 270/83 *Commission v. France (avoir fiscal)*, § 19-20.

to French companies.[683] Fourth, the fact that insurance companies whose registered office is situated in another Member State are at liberty to establish themselves by setting up a subsidiary in order to have the benefit of the tax credit cannot justify different treatment. The second sentence of the first paragraph of Article 49 TFEU expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions.[684]

In a second line of argument, the French government sought to demonstrate that the difference in treatment is in fact due to the particular characteristics of and the differences between the tax systems applying in the various Member States and to the double-taxation agreements. It argued that since the legislation at issue has not been harmonized, different measures are necessary in each case in order to take account of the differences between the taxation systems; those different measures are therefore justified under Article 49 TFEU. Thus, the rules which are being contested in this case would be necessary, in particular, in order to prevent tax evasion. The application of tax legislation to natural persons and companies pursuing their activities in different Member States would be governed by double-taxation agreements.[685]

The ECJ noted, first, that the fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment, because freedom of establishment prohibits the Member States from laying down in their laws conditions for the pursuit of activities by persons exercising their right of establishment which differ from those laid down for its own nationals.[686] Second, the ECJ held that the risk of tax avoidance cannot be relied upon in this context. Freedom of establishment does not permit any derogation from the fundamental principle of freedom of establishment on such a ground. Moreover, the ECJ was not convinced by the calculations submitted by the French government in order to prove the risk of tax evasion.[687] Third, the ECJ decided that the rights conferred by freedom of establishment are unconditional; a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, those rights cannot be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States.

As a consequence, the different treatment between domestic insurance companies and foreign insurance companies operating in France through a permanent establishment constituted a restriction on freedom of establishment which could not be justified.

Manninen

This case concerned Finnish legislation whereby Finland granted a full imputation tax credit to Finnish shareholders in respect of Finnish corporate income tax levied on profits distributed as dividends. No tax credit in respect of foreign corporate income tax levied on foreign-source profits distributed as dividends was, however, granted. The ECJ held that

683 Case 270/83 *Commission v. France (avoir fiscal)*, § 21.
684 Case 270/83 *Commission v. France (avoir fiscal)*, § 22.
685 Case 270/83 *Commission v. France (avoir fiscal)*, § 23.
686 Case 270/83 *Commission v. France (avoir fiscal)*, § 24.
687 Case 270/83 *Commission v. France (avoir fiscal)*, § 25.

free movement of capital (Article 63 TFEU) required Finland to extend this tax credit to account for corporate income tax levied on dividends from another Member State, in this case, Sweden.

To begin with, the ECJ stated that the Finnish tax legislation has the effect of deterring fully taxable persons in Finland from investing their capital in companies established in another Member State. It also has a restrictive effect as regards companies established in other Member States, in that it constitutes an obstacle to their raising capital in Finland. It followed that the Finnish legislation constitutes a restriction on the free movement of capital which is, in principle, prohibited.[688]

The ECJ subsequently examined whether that restriction on the free movement of capital is capable of being justified. It first reviewed whether the difference in treatment of a shareholder fully taxable in Finland according to whether he receives dividends from companies established in that Member State or from companies established in other Member States relates to situations which are not objectively comparable. Importantly, the ECJ noted that the Finnish tax legislation is designed to prevent double taxation of company profits by granting to a shareholder who receives dividends a tax advantage linked to the taking into account of the corporation tax due from the company distributing the dividends.[689] By describing the objective of the Finnish legislation in this way, the ECJ removed the discriminatory element inherent in it: the limitation of the avoidance of economic double taxation to domestic situations. This can be explained by something the ECJ said later in its judgment: whilst, for Finland, granting a tax credit in relation to corporation tax due in another Member State would entail a reduction in its tax receipts in relation to dividends paid by companies in other Member States, it has been consistently held in the case law that reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom.[690]

The ECJ went on to say that, in view of the thus reformulated objective of the legislation, the situation of persons fully taxable in Finland might differ according to the place where they invested their capital. That would be the case in particular where the tax legislation of the Member State in which the investments were made already eliminated the risk of double taxation of company profits distributed in the form of dividends, by, for example, subjecting to corporation tax only such profits by the company concerned as were not distributed. In the present case, however, Sweden levied corporation tax on the distributed dividends. Accordingly, where a person fully taxable in Finland invests capital in a company established in Sweden, there is no way of escaping double taxation of the profits distributed by the company in which the investment is made. In the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State or from a company established in Sweden.[691]

688 Case C-319/02 *Manninen*, § 22-24.
689 Case C-319/02 *Manninen*, § 33.
690 Case C-319/02 *Manninen*, § 49.
691 Case C-319/02 *Manninen*, § 34-36.

The ECJ then noted that the Finnish tax legislation cannot be regarded as an emanation of the principle of territoriality as that principle does not preclude the granting of a tax credit to a person fully taxable in Finland in respect of dividends paid by companies established in other Member States.[692] Next, Finland maintained that its tax legislation is objectively justified by the need to ensure the cohesion of the national tax. In particular it stated that, if a tax credit were to be granted to the recipients of dividends paid by a Swedish company to shareholders who were fully taxable in Finland, the authorities of that Member State would be obliged to grant a tax advantage in relation to corporation tax that was not levied by that State, thereby threatening the cohesion of the national tax system. Answering that defence, the ECJ held that an argument based on the need to safeguard the cohesion of a tax system must be examined in the light of the objective pursued by the tax legislation in question. Having regard to the objective pursued by the Finnish tax legislation, the cohesion of that tax system is assured as long as the correlation between the tax advantage granted in favour of the shareholder and the tax due by way of corporation tax is maintained. Therefore, in a case such as that at issue in the main proceedings, the granting to a shareholder who is fully taxable in Finland and who holds shares in a company established in Sweden of a tax credit calculated by reference to the corporation tax owed by that company in Sweden would not threaten the cohesion of the Finnish tax system and would constitute a measure less restrictive of the free movement of capital than that laid down by the Finnish tax legislation.[693] In a later case the ECJ had the opportunity to clarify that Finland would be obliged to grant a tax credit only up to the limit of the amount of corporation tax for which the company receiving the dividends is liable. It is not required to repay the difference, that is to say, the amount paid in the Member State of the company making the distribution which is greater than the amount of tax payable in the Member State of the company receiving it.[694]

Cadbury Schweppes

This case concerned the UK rules on the taxation of controlled foreign companies. This legislation is designed to apply when the CFC is subject, in the State in which it is established, to a 'lower level of taxation', which is the case, under that legislation, in respect of any accounting period in which the tax paid by the CFC is less than three quarters of the amount of tax which would have been paid in the United Kingdom on the taxable profits as they would have been calculated for the purposes of taxation in that Member State. The taxation provided for by the legislation on CFCs is excluded when 'the motive test' is satisfied. The latter involves two cumulative conditions. First, where the transactions which gave rise to the profits of the CFC produce a reduction in United Kingdom tax compared to that which would have been paid in the absence of those transactions and where the amount of that reduction exceeds a certain threshold, the resident company must show that such a reduction was not the main purpose, or one of the main purposes, of those transactions. Secondly, the resident company must show that it was not the main reason, or one of the main reasons, for the CFC's existence to achieve a reduction in

692 Case C-319/02 *Manninen*, § 38.
693 Case C-319/02 *Manninen*, § 43-46.
694 Case C-446/04 *Test Claimants in the FII Group Litigation*, § 50-52.

United Kingdom tax by means of the diversion of profits. According to that legislation, there is a diversion of profits if it is reasonable to suppose that, had the CFC or any related company established outside the United Kingdom not existed, the receipts would have been received by, and been taxable in the hands of, a United Kingdom resident.[695] Clearly, the CFC legislation is designed in such a way that the profits of a non-resident subsidiary of a UK parent company remain taxable in the UK in situations which the UK legislature regards as abusive.

To begin with, the ECJ observed that the CFC legislation does not apply in situations involving domestic subsidiaries or foreign subsidiaries which are resident in a Member State with a level of taxation which is not 'lower'. This implies a restriction on freedom of establishment.[696] The ECJ then stated that such a restriction is permissible only if it is justified by overriding reasons of public interest and if its application is appropriate to ensuring the attainment of the objective thus pursued and does not go beyond what is necessary to attain it.

Various governments submitted that the legislation on CFCs is intended to counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax State by means of the establishment of a subsidiary in that State. In this respect, the ECJ reiterated its settled case law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorize that Member State to offset that advantage by less favourable tax treatment of the parent company. The need to prevent the reduction of tax revenue is not a matter of overriding general interest which would justify a restriction on a fundamental freedom. Also, the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom. [697]

On the other hand, a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State. It is necessary, in assessing the conduct of the taxable person, to take particular account of the objective pursued by the freedom of establishment. The concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. Consequently, it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there. It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. Such an artificial shifting of taxable profits from one tax jurisdiction to

[695] Case C-196/04 *Cadbury Schweppes*, § 7-11.
[696] Case C-196/04 *Cadbury Schweppes*, § 43-46.
[697] Case C-196/04 *Cadbury Schweppes*, § 48-50.

another would undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus to jeopardize a balanced allocation between Member States of the power to impose taxes.[698]

The ECJ then observed that the inclusion of the profits of a CFC in the tax base of the resident company makes it possible to thwart practices which have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory. Such legislation is therefore suitable to achieve the objective for which it was adopted.

Finally, the ECJ determined whether that legislation goes beyond what is necessary to achieve that purpose. Here, the ECJ examined to what extent the UK legislation is overinclusive in relation to its objective as formulated in the justification stage in which the illegitimate objectives were filtered out. The ECJ stated that in order to find that there is a wholly artificial arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by EU law, the objective pursued by freedom of establishment has not been achieved. In order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality: an actual establishment intended to carry on genuine economic activities in the host Member State. Insofar as the CFC legislation covers more situations, it is overinclusive.

Oy AA

The case of *Oy AA* illustrates the idea of a 'twofold neutrality' very well: the application of the free movement provisions should not render direct tax sovereignty meaningless (see section 7.4.1). This case concerned the Finnish system of group contribution. The purpose of this system is to remove tax disadvantages inherent in the structure of a group of companies by allowing a balancing out within a group that comprises both profit-making and loss-making companies. An intra-group financial transfer is regarded as an expense of the transferor and is deducted from that person's taxable income only if it is recorded as income of the transferee. In a cross-border situation, where the transferee is not subject to tax in Finland, a group contribution is not possible. The question arises as to whether this contravenes freedom of establishment.

The ECJ started off by noting that, in relation to the possibility of deducting as expenses a transfer made in favour of the parent company, the legislation introduces a difference in treatment between subsidiaries established in Finland according to whether or not their parent company has its corporate seat in that same Member State. This difference does not follow from any incomparability of domestic and foreign parent companies of the aim pursued by the Finnish system. As a consequence, the Finnish system constitutes an obstacle to the freedom of establishment. The ECJ emphasized that this conclusion cannot be called into question by the argument that the parent company could have attained the objective pursued by creating a branch in Finland rather than a subsidiary.[699] It is important

[698] Case C-196/04 *Cadbury Schweppes*, § 51-55.
[699] Case C-231/05 *Oy AA*, § 31-40.

to observe that the ECJ – just like it did in *Manninen* above – removes the discriminatory element from the aim of the system when performing comparability analysis.

The ECJ then went on to examine whether the restriction on freedom of establishment can be justified, and if so, whether it is appropriate and necessary to ensuring the attainment of its objective. The ECJ first dealt with the need to safeguard a balanced allocation of the power to tax between Member States. It pointed out that that need cannot justify a Member State systematically refusing to grant a tax advantage to a resident subsidiary, on the ground that the income of the parent company, having its establishment in another Member State, is not capable of being taxed in the first Member State. That element of justification may be allowed, however, where the system in question is designed to prevent conduct capable of jeopardizing the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory. To accept that an intra-group cross-border transfer may be deducted from the taxable income of the transferor would result in allowing groups of companies to choose freely the Member State in which the profits of the subsidiary are to be taxed, by removing them from the basis of assessment of the latter and, where that transfer is regarded as taxable income in the Member State of the parent company, incorporating them in the basis of assessment of the parent company. That would undermine the system of the allocation of the power to tax between Member States because, according to the choice made by the group of companies, the Member State of the subsidiary would be forced to renounce its right, in its capacity as the State of residence of that subsidiary, to tax the profits of that subsidiary in favour, possibly, of the Member State in which the parent company has its establishment. Concerning, secondly, the alleged risk – submitted by various governments – that losses might be used twice, the ECJ found it sufficient to point out that the Finnish system of intra-group financial transfers does not concern the deductibility of losses. Concerning, thirdly, the prevention of tax avoidance, the ECJ acknowledged that the possibility of transferring the taxable income of a subsidiary to a parent company with its establishment in another Member State carries the risk that, by means of purely artificial arrangements, income transfers may be organized within a group of companies towards companies established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed. That possibility is reinforced by the fact that the Finnish system of intra-group financial transfers does not require the transferee to have suffered losses. The combination of these two factors lead the ECJ to the conclusion that the refusal of cross-border group contributions pursues legitimate objectives compatible with EU law and justified by overriding reasons in the public interest, and is appropriate to ensuring the attainment of those objectives.[700]

It must, however, still be examined whether or not such a system goes beyond what is necessary to attain all of the objectives pursued. The ECJ noted at the outset that the objectives of safeguarding the balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance are linked. Conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the Member States to exercise

[700] Case C-231/05 *Oy AA*, § 53-60.

their tax jurisdiction in relation to those activities and jeopardize a balanced allocation between Member States of the power to impose taxes. Any extension of the system of group contributions to cross-border situations would have the effect of allowing groups of companies to choose freely the Member State in which their profits will be taxed, to the detriment of the right of the Member State of the subsidiary to tax profits generated by activities carried out on its territory. That detriment cannot be prevented by imposing conditions concerning the treatment of the income arising from the intra-group financial transfer in the Member State of the transferee, or concerning the existence of losses made by the transferee.

As a result, freedom of establishment (Article 49 TFEU) did not preclude the refusal of cross-border group contributions.[701]

Papillon

Société Papillon is a company resident in France. It owns 100% of the shares in Artist Performance and Communication BV (APC), a company resident in the Netherlands. APC holds 99.99% of the shares in SARL Kiron which is a resident of France. In turn, Kiron holds the shares in various French group companies. Papillon applied for the French group consolidation regime (*intégration fiscale*) per 1 January 1989. It wanted to consolidate the results of Papillon, Kiron and Kiron's French subsidiaries, whilst excluding APC from the consolidation. The French tax authorities, however, rejected this request on the grounds that i) group consolidation is only possible in the case of an 'uninterrupted chain' of shareholdings between the companies concerned, combined with the circumstances that ii) all companies in the 'uninterrupted chain' have to be part of the consolidated group and iii) non-resident group companies cannot be consolidated. Since APC was not tax resident in France, group consolidation between Papillon, Kiron and Kiron's French subsidiaries was not possible. Papillon claimed that this rejection contravened Article 49 TFEU (freedom of establishment). The French *Conseil d'État* decided to refer the case to the ECJ.

The ECJ noted that a French parent company which holds its French sub-subsidiaries through a subsidiary established in another Member State cannot benefit from the tax integration regime. By contrast, a French parent company is able to achieve tax integration with its French sub-subsidiaries where the intermediate subsidiary is established in France. The ability to elect for the tax integration regime is accordingly dependent on whether the parent company holds its indirect shares through a subsidiary established in France or in another Member State. Consequently, EU situations are put at a disadvantage compared with purely domestic situations.[702] This restriction on freedom of establishment is, in principle, prohibited unless it is justified by overriding reasons of public interest and

[701] Case C-231/05 *Oy AA*, § 61-65.

[702] Already in Case C-200/98 *X AB & Y AB*, the ECJ held that a refusal of the group contribution regime for a resident parent company and a resident sub-subsidiary on the ground that the parent company held the shares in the sub-subsidiary indirectly through a non-resident intermediate subsidiary, constituted a restriction on freedom of establishment. The case of *Papillon* has a very similar fact pattern. The legal context is however very different, because French group taxation is only possible if all of these companies are consolidated. The Swedish group contribution regime did not have such a requirement.

its application is appropriate and necessary to ensuring the attainment of the objectives of the French system. In this regard the ECJ held that the restriction cannot be justified by the need to preserve the allocation of the power to impose taxes between Member States. The question as to whether the profits and losses of companies belonging to the group in question should be taken into account will arise only in relation to companies which are resident in France. This also excludes, *prima facie*, a risk of tax avoidance. The restriction can, however, possibly be justified by the need to ensure the coherence of the tax system. The neutralisation of intra-group transactions is an important objective of the group consolidation regime. If a non-resident group company is not part of the consolidated group, it may not always be possible to fully achieve this objective if the French sub-subsidiary suffers a loss. After all, that loss may be taken into account both at the level of the consolidated group and at the level of the French parent company through a write-down of the shares in the non-resident group company. It is however disproportionate to exclude the possibility of group consolidation altogether. In this respect, the ECJ first pointed out that practical difficulties cannot of themselves justify the infringement of a freedom guaranteed by the Treaty. Moreover, Council Directive 77/799/EEC allows France to request from the competent authorities of the other Member States all relevant information. In addition, the French tax authorities are entitled to demand from the parent company such documents as they consider necessary to determine whether the provisions made by that company for the losses in share values in the subsidiary can be explained indirectly by a loss of the sub-subsidiary through the provisions of that subsidiary. Accordingly, group consolidation between Papillon, Kiron and Kiron's French subsidiaries should in principle be possible.

8.3.2 Relation to the theoretical optimization model

8.3.2.1 Introduction

The theoretical optimization model requires that the tax measure which leads to a 'disadvantage' has a 'respectful aim' and that the EU free movement provision which affects this tax measure is also respectful towards the principle of tax sovereignty. This is the idea of a 'twofold neutrality'. This means that direct tax measures should *in abstracto* 'accept' that they may be limited by the principle of free movement. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. No other requirements may be imposed, apart from being formally and substantively compatible with other principles enshrined in the TEU and the TFEU (section 7.4.1). This section analyzes to what extent the case law discussed in section 8.3.1 fits into these theoretical principles. First, however, it will be reviewed how the ECJ determines the aim of a national measure and how it deals with a plurality of objectives.

8.3.2.2 Aim determination and a plurality of objectives

How to determine the aim of a measure?
It may be difficult to discover which aim exactly underlies a certain rule. This is a problem with which every court is familiar; it should be solved though the normal rules of interpretation. It has been argued in section 4.5.2 that the courts should actively investigate the existence of any underlying – perhaps less noble – motive. They can have recourse to the legislative history of the measure, the system of the law of which the measure is a part, the social and political circumstances under which it was enacted and the effects generated by the provision. The case of *Finalarte*, discussed in 8.3.1.2, shows that the ECJ's case law is perfectly in line with the theoretical optimization model in this respect. It has also been argued in section 4.5.2 that, if a rule *prima facie* infringes a certain principle without any known 'real' objective, this may be an indication that its objective coincides with its effects, i.e. to limit that principle, as a consequence of which it cannot be regarded as respectful. The case of *Finalarte* also seems to support this view because that judgment states that the effects of a national measure are very important to determine its objective.

How to deal with a plurality of objectives?
The ECJ has accepted in *Campus Oil* and *Nertsvoederfabriek Nederland* that the achievement of an economic aim might be necessary for the achievement of a public interest aim. If that is the case, the measure overall pursues a legitimate objective, notwithstanding any other economic – and therefore illegitimate – objectives (section 8.3.1.2). In section 4.5.2 it has been suggested that courts should, in the case of a plurality of objectives, investigate on a case-by-case basis whether the measure would also be justified if the unacceptable goal were eliminated. There does not seem to be much light between both tests. For example, any restrictive tax measure also has a budgetary background. If there is no other reason which may serve as a justification, the tax measure is prohibited. What matters is whether the disrespectful objective of a tax measure serves to achieve another respectful objective. If this is the case, the disrespectful objective is an unavoidable consequence, which does not invalidate the measure. The case of *Cadbury Schweppes*, discussed in section 8.3.1.4, may illustrate this. The CFC legislation in this case partially disallowed a company to set up a secondary establishment in another Member State in order to benefit from a more beneficial tax regime there. This aim cannot be regarded as respectful, because it fundamentally denies the existence of freedom of establishment. However, insofar as the objectives of freedom of establishment coincide with the aim of the prevention of tax evasion, the latter respectful aim may justify the measure to that extent. In summary, ECJ case law seems to be in conformity with the theoretical optimization model. A final example which may illustrate the point is the State aid case of *Gibraltar v. Commission*.[703] Gibraltar decided, in the exercise of its tax sovereignty, to replace the system of corporate income tax by two other taxes: a tax on occupation of business property and a payroll tax, together capped at 15% of profits. This tax system is beneficial for offshore companies without significant presence or staff in Gibraltar. This effect does not result, however, in

[703] Joined Cases C−106/09 P and C−107/09 P *Commission and Spain v Gibraltar and United Kingdom*

an advantage for these companies within the meaning of Article 107 TFEU. If it were otherwise, Gibraltar would be precluded form designing its tax system on the basis of payroll and occupation of business property, which are both aimed at taxing scarce production factors. This in itself respectful aim should be able to be pursued by Gibraltar: the prohibition of State aid would be disrespectful towards the principle of tax sovereignty if it would positively prescribe how Gibraltar should design its tax system.

8.3.2.3 Direct tax measures which are disrespectful towards free movement

Introduction

It is settled case law that (tax) measures which discriminate directly on grounds of nationality cannot be justified unless a specification Treaty derogation applies. Apparently, these measures do not meet the ECJ's requirement that a restrictive rule has to pursue an objective which is 'legitimate'. This is also, as appears from section 8.3.1.3, the case for tax measures which are allegedly justified by one of the following reasons: budgetary reasons, protection of the tax base, the existence of other tax advantages to compensate for the alleged tax disadvantage, the availability of an alternative legal or business form and the lack of EU harmonization concerning the impugned national tax measure. These are now reviewed.

Directly discriminatory direct tax rules

The classic four freedoms of the TFEU – free movement of goods, persons, services and capital – all prohibit distinctions which are directly based on the origin of the product or on the (foreign) nationality of the taxpayer concerned. Such distinctions can only be justified on grounds of the express treaty derogations (section 8.3.1.3). This is problematic in view of the theoretical optimization model. The above-discussed case of *Royal Bank of Scotland*, where the ECJ held in general terms that the discrimination in that case could be justified only on grounds of the express Treaty derogations, is at odds with the model because it categorically states that a tax measure which directly distinguishes on grounds of nationality of the taxpayer is disrespectful towards the principle of free movement. Under the theoretical optimization model, however, no principle can be absolute; any other rule or principle should be able to serve as its limit. This would be different if a third principle would come into play: the formal principle that that rules passed by an authority acting within its jurisdiction are to be followed (see section 4.2).[704] If the EU Member States would have decided that the prohibition of direct discrimination should be regarded as a rule which the ECJ cannot alter due to formal principles, the optimization process would already have been performed by the Contracting States. In my view, however, EU Member States cannot have envisaged such a rule, which is shown by the examples discussed below in which a direct discrimination seems to make perfect sense. Of course, a distinction directly on grounds of nationality may be subject to an intense review of the degree of fit of the measure (section 4.5.4), but an outright prohibition of such a distinction is not in line with the model.

[704] Kumm 2004, p 578; Alexy 2002, p 58.

This is echoed not only by the above-discussed cases of *Campus Oil* and *Nertsvoeder-fabriek Nederland*, but also by the ECJ's judgment in *ADBHU*, where it was held "that the principle of freedom of trade is not to be viewed in absolute terms but is subject to certain limits justified by the objectives of general interest".[705] The ECJ has recognized this in its case law by operating a balanceable notion of discrimination which it uses to 'escape' the notion that direct discrimination can only be justified on the grounds expressly mentioned in the Treaty. An example of this mechanism is provided by the *Walloon waste* case.[706] In that case the Commission argued that Belgium had infringed Articles 34 and 36 TFEU by prohibiting the storage, tipping or dumping in Wallonia of waste originating in another Member State or in a region of Belgium other than Wallonia. The ECJ first stated that waste, whether recyclable or not, is to be regarded as "goods", the movement of which must in principle not be prevented. To justify the restrictions placed on the movement of waste, Belgium argued that the contested legislation meets imperative requirements relating to environmental protection and the objective of protection of health, which takes precedence over the objective of freedom of movement for goods, and constitutes an exceptional and temporary protective measure to counter the inflow into Wallonia of waste from neighbouring countries. With respect to the environment, it is important to note that waste is matter of a special kind. The ECJ considered this argument to be well founded. Accumulation of waste, even before it becomes a health hazard, constitutes a danger to the environment, regard being had in particular to the limited capacity of each region or locality for waste reception. In view of the abnormally large-scale inflow of waste from other regions for tipping in Wallonia, there was a real danger to the environment, having regard to the limited capacity of that region. The Commission argued, however, that those imperative requirements cannot be relied upon in the present case, given that the measures in question discriminate against waste originating in other Member States, which is no more harmful than waste produced in Wallonia. In other words, there is a 'direct' discrimination on the basis of the origin of the product which can only be justified on grounds of the express Treaty derogations. The ECJ admitted that imperative requirements can indeed be taken into account only in the case of measures which apply without distinction to both domestic and imported products. Subsequently, the ECJ specified this requirement so that it only prohibits arbitrary discrimination on grounds of the origin of the product. The arbitrariness of a certain distinction is found through a balancing exercise:

> "34. (…) in assessing whether or not the barrier in question is discriminatory, account must be taken of the particular nature of waste. The principle that environmental damage should as a matter of priority be remedied at source, laid down by [Article 191 TFEU] as a basis for action by the Community relating to the environment, entails that it is for each region, municipality or other local authority to take appropriate steps to ensure that its own waste is collected, treated and

[705] Case 240/83 *ADBHU*, § 12.

[706] Case C-2/90 *Commission v Belgium* (Walloon waste). The case is discussed extensively by Bengoetxea, MacCormick & Moral Soriano 2001, p 74-76. See for a critical analysis Hilling 2005, p 101-102.

> disposed of; it must accordingly be disposed of as close as possible to the place where it is produced, in order to limit as far as possible the transport of waste.
> 35. Moreover, that principle is consistent with the principles of self-sufficiency and proximity set out in the Basel Convention of 22 March 1989 on the control of transboundary movements of hazardous wastes and their disposal, to which the Community is a signatory (…).
> 36. It follows that having regard to the differences between waste produced in different places and to the connection of the waste with its place of production, the contested measures cannot be regarded as discriminatory."

Thus, according to Bengoetxea, MacCormick and Moral Soriano, the test of non-arbitrary discrimination promotes coherence within the legal system because it requires that plausible connections be made among colliding reasons, all of them belonging to the same legal theory.[707] It is remarkable that the ECJ not only refers to the free movement of goods and to environmental protection but also to an external treaty. Bengoetxea, MacCormick and Moral Soriano note:

> "What is important is not the systematic order of principles but rather the promotion of all of them (demand of proportionality). A measure such as that established by Wallonia restricts free movement of goods but promotes a high level of environmental protection, the principle that damage should be remedied at its source, and the principle that the polluter pays (…). The Court understands proportionality in Alexy's sense: as a command to optimize, that is, as a command to find an equilibrium among all colliding interests and values. The criterion to be followed is 'the more intensive the interference in one principle is, the more important must be the realization of the other principle'.[708] So an interference into the principle of non-discrimination and free movement of goods is justified by the realization of other (equally important) principles."[709]

It would, in view of the theoretical optimization model, be recommendable that the ECJ explicitly drops the notion that direct discrimination can only be justified on the grounds expressly mentioned in the Treaty.

Budgetary reasons
It appears from the case law discussed in 8.3.1.4 (e.g. *Manninen*) that budgetary reasons can never justify a restriction on free movement.[710] This is fully in line with the theoretical optimization model. Restrictive tax measures can only be regarded as 'respectful' if they can be justified on grounds other than tax sovereignty itself (a principle cannot determine its own extent; see section 7.4.4). Budgetary reasons cannot, therefore, be regarded as

[707] Bengoetxea, MacCormick & Moral Soriano 2001, p 76.
[708] Original footnote: "Alexy, 'Rights, Legal Reasoning and Rational Discourse', (1992) 5 Ratio Juris 150."
[709] J Bengoetxea, MacCormick & Moral Soriano 2001, p 76.
[710] Compare also Case C-484/93 *Svensson and Gustavsson*, § 15; Case C-96/08 CIBA, § 48.

respectful. If it were otherwise, the extent of tax sovereignty would be unlimited and absolute. In *Orange European Smallcap Fund*, however, the ECJ left open the question whether a loss of tax revenue may justify a restriction on free movement of capital in relation to third countries.[711] This is odd in view of the theoretical optimization model. In *Haribo*, AG Kokott has, therefore, rightly concluded that a reduction of tax revenue cannot justify a restriction of free movement of capital from and towards third countries, because this would render Article 63 TFEU meaningless in these situations.[712] In other words, the principle of tax sovereignty would be disrespectful towards the principle of free movement.

Practical difficulties
In *Papillon*, the ECJ reiterated its settled case law that practical difficulties cannot of themselves justify the infringement of a freedom guaranteed by the Treaty. This seems to be in line with the theoretical optimization model. The permissibility of an infringement of the principle of free movement on this ground alone would essentially mean that the principle of tax sovereignty would become unlimited; to a certain extent there are always practical difficulties. This would go against the very nature of a principle: it should accept that it may be limited by a competing principle.

Protection of the tax base
The same is true for anti-abuse measures which apply solely because a taxpayer has established itself in another Member State with a low effective tax rate. Again, such an objective disrespects the principle of free movement because it negates the very existence of a competing principle (the principle of free movement). The above-discussed judgment in *Cadbury Schweppes* is a good illustration of this. Indeed, the ECJ already stated in *Eurowings* that "such compensatory tax arrangements prejudice the very foundations of the single market."[713]

Availability of an alternative legal or business form
In the above-discussed cases of *Avoir Fiscal* and *Oy AA,* the ECJ rejected the argument that the taxpayer could have used an alternative business form – e.g. a subsidiary instead of a permanent establishment – in which case no tax disadvantage would have occurred. The second sentence of the first paragraph of Article 49 TFEU expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions, the ECJ said. This statement is fully in line with the theoretical optimization model. A tax measure which restricts free choice of legal form for no reason other than doing precisely that does not respect the principle of freedom of establishment. If it were otherwise, the extent of tax sovereignty would be unlimited and absolute, which is not possible for a 'principle' which should be prepared to engage in optimization with other principles (section 4.5.2).

711 Case C-194/06 *Orange European Smallcap Fund*, § 93-96.
712 Opinion of AG Kokott in Joined Cases C-436/08 and C-437/08 *Haribo and Österreichische Salinen*, § 125. See § 126 of the judgment itself.
713 Case C-294/97 *Eurowings*, § 45. See also Case C-136/00 *Danner*, § 56.

Existence of other tax advantages to compensate for the alleged tax disadvantage
In the above-discussed case of *Avoir Fiscal,* the ECJ held that unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages.[714] The theoretical optimization model supports this, because the principle of tax sovereignty would be unlimited and absolute if it could freely limit the application of other principles on the basis of its own application in other situations of collision with these principles. In other words, the limit (the national tax measure) to a principle (free movement) would determine its own extent. As explained in section 4.5.2, this would be disrespectful towards competing principles.

The lack of EU harmonization concerning the impugned national tax measure
In *Avoir Fiscal* the ECJ also rejected the defence that a national restrictive tax measure could be justified by the fact that there is (almost) no positive EU harmonization in direct taxation. Obviously, this is supported by the theoretical assessment model. If the principle of tax sovereignty did not accept that it can be limited as long as there is no positive EU harmonization, it would flagrantly disrespect the principle of free movement.

8.3.2.4 Situations where free movement is disrespectful towards tax sovereignty

Introduction
The case law discussed in section 8.3.1.4, but also in section 8.2.1, has not only revealed situations where the principle of tax sovereignty is disrespectful towards free movement, but also situations where the opposite situation occurs. The cases of *Gilly* and *Oy AA* are good examples, as will be discussed now.

A prohibition of taxation as such is disrespectful
The principle of proportionality is generally not capable of providing for limits which the legislature has to observe when enacting direct tax rules which are mainly aimed at collecting public resources (section 7.4.2). In these cases the *petitum* or claim of the applicant which should make it clear to the court what it should decide in the event that it would find in favour of the applicant, in fact implies a request for abandoning direct taxes as such. Clearly, such a claim cannot be sustained, because it would deny the existence of a State's direct tax sovereignty (the principle of free movement would not be respectful to the principle of direct tax sovereignty; see section 4.5.2). The case of *Gilly*, discussed in section 8.2.1.2, clearly supports this aspect of the theoretical optimization model. In this case the ECJ held that a Member State does not have to refund to a resident taxpayer any income tax levied by another Member State in order to align the total tax burden of the taxpayer in line with the tax burden in a purely domestic situation. The ECJ explained this, *inter alia,* as follows:

> "if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would

[714] See also Case C-182/06 *Lakebrink*, § 24; compare also Case C-330/91 *Commerzbank*, § 19; Case C-293/06 *Deutsche Shell*, § 40.

> have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation."[715]

This statement is perfectly understandable if one recognizes that the principle of free movement should respect the principle of tax sovereignty: the idea of a twofold neutrality (section 7.4.1).

A prohibition to determine the organization and aims of the tax system is disrespectful
The *prima facie* right to be able to determine the organization and aims of the tax system within the domestic jurisdiction should serve as a limit to free movement, because the principle of free movement has to be respectful towards the principle of tax sovereignty (section 7.4.2). If the principle of free movement did not respect the core aspect of the principle of direct tax sovereignty that a State may design its tax system as it sees fit and to pursue any measure of general tax policy or any other policy through that system, if would have the pretention to prescribe itself what a 'good' tax system should look like. As a result, the principle of free movement would not accept that it may be limited by the principle of tax sovereignty: it would be disrespectful. A good example in ECJ case law is provided by the above-discussed case of *Oy AA*. This case concerned the Finnish system of group contribution. The purpose of this system is to remove tax disadvantages inherent in the structure of a group of companies by allowing a balancing-out within a group that comprises both profit-making and loss-making companies. An intra-group financial transfer is regarded as an expense of the transferor and is deducted from that person's taxable income only if it is recorded as income of the transferee. In a cross-border situation, where the transferee is not subject to tax in Finland, a group contribution is not possible. The ECJ held, essentially, that a Member State is free to design a system of group taxation within its domestic jurisdiction. This is the starting point. The next step is to verify whether there are legitimate reasons for not applying this system in cross-border situations. The ECJ answered this question in the affirmative: if the principle of free movement were to force the Member State concerned to extend its group contribution regime cross-border, it would in fact deprive that Member State of the right to regulate within its domestic jurisdiction (it would no longer be possible to tax the profits which are under international tax law attributable to that Member State).[716] This would in fact mean that the principle of free movement would prohibit a Member State from operating a system of group contribution under penalty of being unable to collect public resources, which would be disrespectful to the aforementioned starting point. The following considerations of the ECJ show, in my view, that this is indeed what the ECJ has said:

> "64. In a situation in which the advantage in question consists in the possibility of making a transfer of income, thereby excluding such income from the taxable income of the transferor and including it in the taxable income of the transferee,

[715] Case C-336/96 *Gilly*, § 48.
[716] This was not the case in Joined Cases C-397/98 and C-410/98 *Metallgesellschaft and Hoechst*, § 52-54.

> any extension of that advantage to cross-border situations would (…) have the effect of allowing groups of companies to choose freely the Member State in which their profits will be taxed, to the detriment of the right of the Member State of the subsidiary to tax profits generated by activities carried out on its territory.
> 65. That detriment cannot be prevented by imposing conditions concerning the treatment of the income arising from the intra-group financial transfer in the Member State of the transferee, or concerning the existence of losses made by the transferee. To allow deduction of the intra-group financial transfer where it constitutes taxable income of the transferee company, or where the opportunities for the transferee company to transfer its losses to another company are limited, or to allow deduction of an intra-group financial transfer in favour of a company whose establishment is in a Member State applying a lower rate of tax than that applied by the Member State of the transferor only where that intra-group financial transfer is specifically justified by the economic situation of the transferee, as Oy AA has proposed, would nevertheless mean that, in the final analysis, the choice of the Member State of taxation would be a matter for the group of companies, which would have a wide discretion in that regard."

In my view, these considerations are based on the idea of a twofold neutrality (section 7.4.1), as a result of which ECJ case law is in line with the theoretical optimization model. The case of *Cadbury Schweppes*, discussed in section 8.3.1.4, may serve as another example. The CFC legislation in this case partially disallowed a company to set up a secondary establishment in another Member State in order to benefit from a more beneficial tax regime there. This aim cannot be regarded as respectful, because it fundamentally denies the existence of freedom of establishment. However, insofar as it coincides with the aim of the prevention of tax evasion, the latter respectful aim may justify the measure to that extent. The principle of free movement would disrespect the principle of tax sovereignty if it did not allow a Member State to prevent tax evasion by wholly artificial arrangements which would deprive a Member State of the right to tax the profits of a company which are attributable to economic activities in its jurisdiction. In such a case, free movement would not accept tax sovereignty as a limit. In summary, ECJ case law seems to be in conformity with the theoretical optimization model.

The question arises as to how *Oy AA* relates to the judgment in *Marks & Spencer*.[717] In this latter case, which concerned the UK system of group relief (surrender of losses between group companies), the ECJ obliged the UK to accept foreign losses from a non-resident subsidiary if the possibilities of using the losses had been exhausted in the subsidiary's Member State and the parent company demonstrated this. In contrast, the ECJ did not oblige Finland to accept a cross-border transfer of profits by a Finnish subsidiary to its UK parent company in a 'final loss' situation. In my view, the difference between both cases is reflected in the different design of both systems. The transfer of *profits* in a group contribution system is possible regardless of the existence of losses at the level of the recipient company. If the principle of free movement required that this system be changed so as to allow a cross-border group contribution in a 'final loss' situation, it would

[717] Case C-446/03 *Marks & Spencer*, discussed in section 2.4.

impose an entirely new element in that system for which the principle of free movement has no authority: it would be disrespectful towards Finnish tax sovereignty. In a system of group relief, however, the ECJ could require that losses be surrendered under certain circumstances, without changing the essence of the system.

What happens if the right to determine the objectives of the tax system is disrespected?
The ECJ's case law becomes unpredictable and arbitrary if the ECJ disregards the respectful objectives which underlie a certain tax measure (in such a case the principle of free movement would disrespect the principle of tax sovereignty). A striking example is provided by the rules established in the cases of *Fokus Bank*, *Amurta, Commission v. Italy* and *Commission v. Spain*.[718] These cases all concerned a withholding tax on dividends which was applicable only to non-resident recipients, in a situation where a resident recipient was (effectively) exempt from corporate income tax on the dividend. The background of the exemption of resident shareholders from taxation on the dividend is the wish to avoid economic double taxation of the dividend. The ECJ and the EFTA Court both decided that the disadvantageous treatment of a dividend paid to non-resident shareholders constitutes a restriction on free movement of capital which cannot be justified. Subsequently, the ECJ went a step further by holding in *Amurta* that a bilateral tax treaty may enable the effects of this restriction on the free movement of capital to be neutralized in the State of residence of the taxpayer. A unilateral tax credit in the residence State would in any event not suffice, because the source State has not made sure in such a case that the effects of the restriction caused by its legislation are neutralized.[719] In *Commission v Italy* the ECJ tried to give a more precise meaning to this concept of 'neutralization'. The ECJ reiterated that the possibility cannot be excluded that a Member State might succeed in ensuring compliance with its obligations under the Treaty by concluding a convention for the avoidance of double taxation with another Member State. It is, however, necessary for that purpose that application of the double taxation convention allows the effects of the difference in treatment under national legislation to be compensated for. The difference in treatment between dividends distributed to companies established in other Member States and those distributed to resident companies does not totally disappear unless the tax withheld at source under national legislation can be set off against the tax due in the other Member State in the full amount of the difference in treatment arising under the national legislation.[720] The ECJ then held that the grant of an ordinary tax credit in the State of residence cannot, generally speaking, neutralize the discriminatory taxation of non-resident shareholders:

> "38. In this case, such a set-off against the tax due in the other Member State of the tax withheld at source in Italy is not guaranteed by Italian legislation. Set-off presupposes, in particular, that dividends coming from Italy are sufficiently taxed in the other Member State. As the Advocate General has pointed out in paragraphs

[718] Case E-1/04 *Fokus Bank*, Case C-379/05 *Amurta*, Case C-540/07 *Commission v. Italy*; Case C-487/08 *Commission v. Spain*.
[719] Case C-379/05 *Amurta*, § 78 and 83.
[720] Case C-540/07 *Commission v. Italy*, § 36-37.

> 58 and 59 of her Opinion, if those dividends are not taxed, or are not sufficiently taxed, the sum withheld at source in Italy or a part thereof cannot be set off. In that case, the difference in treatment arising from the application of national legislation cannot be compensated for by applying provisions of the double taxation convention.
> 39. The choice as to whether to tax income from Italy in the other Member State, or the level at which it is to be taxed, depends not on the Italian Republic but on the tax rules laid down by the other Member State. The Italian Republic is therefore wrong to argue that set-off of the tax withheld at source in Italy against the tax due in the other Member State, pursuant to the provisions of conventions for the avoidance of double taxation, allows in all cases for the difference in treatment arising from the application of national legislation to be compensated for.
> 40. The Italian Republic cannot therefore argue that, by reason of the application of conventions for the avoidance of double taxation, dividends distributed to companies established in other Member States are not, in the final analysis, treated differently from dividends distributed to resident companies."

Open questions are what happens in a case where the grant of an ordinary tax credit in the State of residence has led to a full refund of foreign withholding tax in a concrete case and what happens if only a partial refund has been granted. Does a partial discrimination in the source State occur in that situation? The case of *Commission v. Spain* has not resolved this issue.[721]

The answers to these and similar questions are wholly unpredictable, which is caused by the fact that the ECJ has misinterpreted the basic objectives of the tax measures in question. As a result, the ECJ will have to create its own benchmark without being able to have recourse to the aims of the national tax system. This can be explained as follows. The (effective) exemption of resident shareholders from taxation on the dividend is aimed at the avoidance of economic double taxation of the dividend. This objective cannot be regarded as disrespectful towards free movement. The taxation of a cross-border dividend, however, cannot be explained by this objective in a situation where the dividend is exempt from taxation in the residence State of the shareholder. In such a case, the source State can attain the objective of avoiding economic double taxation. As a consequence, it should (effectively) exempt the dividend – there is no respectful objective which supports another conclusion.[722] Conversely, the taxation of a cross-border dividend can be explained in a situation where the dividend is taxable in the residence State of the shareholder. In such a case, the source State is unable to achieve the objective of avoiding economic double taxation. As a consequence, it cannot be regarded as disrespectful towards the principle of free movement if the source State taxes the cross-border dividend. *Ad impossibile nemo tenetur*. In such a case the disadvantageous treatment of a cross-border dividend is not motivated by purely budgetary reasons, but by the fact that the objective of avoiding economic taxation cannot be achieved.

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721 Case C-487/08 *Commission v. Spain*, § 62 and 67.

722 This explains Case C-170/05 *Denkavit*. This case was, therefore, rightly decided.

This means that the case law established in *Fokus Bank*, *Amurta*, *Commission v. Italy* and *Commission v. Spain* is unfortunate. It is obvious that the question of whether the dividend is taxable in the residence State of the shareholder is relevant in the light of the objective of avoiding economic double taxation.[723] The criterion of 'neutralization' by a tax credit prescribed by a bilateral tax treaty between the source State and the residence State of the shareholder – developed in *Amurta* and *Commission v. Italy* – has no basis whatsoever in the objectives of the restrictive tax measures at issue in those cases. After all, it is wholly irrelevant in the light of those objectives whether the residence State grants a tax credit at all, unilaterally of bilaterally, for a withholding tax, because this tax credit aims at avoiding international *juridical* double taxation instead of *economic* double taxation. The wrong approach taken by the ECJ has resulted in a situation where the ECJ itself has to interpret what 'neutralization' means. This cannot be regarded as respectful to the principle of tax sovereignty, because the principle of free movement cannot impose a concept of its own of reasonable and correct law-making (section 7.4.4). If the ECJ had found – as it should have – that a source State is under no obligation to avoid economic double taxation insofar as the residence State of the shareholder makes it impossible to achieve this, the ECJ could have spared itself a lot of trouble.

Another example of a case where the ECJ did not respect the aim of the national tax measure is *CLT-UFA*.[724] This case concerned the company CLT-UFA with its seat and central administration in Luxembourg and a branch in Germany. The German tax administration set the tax rate at 42% of the taxable income of the branch. CLT-UFA submitted that this tax rate was discriminatory and that it infringed its right to freedom of establishment under Article 49 TFEU. It sought a reduction of the tax rate to 30% of taxable income on the ground that subsidiaries of a non-resident parent company were entitled to such a tax rate if they distributed their profits to the parent company (a split rate system for the avoidance of economic double taxation; see section 5.4.2). The ECJ ruled in favour of the taxpayer. It considered that the second sentence of the first paragraph of Article 49 TFEU expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that this freedom of choice must not be limited by discriminatory tax provisions. Therefore, the freedom to choose the appropriate legal form in which to pursue activities in another Member State primarily serves to allow companies having their seat in a Member State to open a branch in another Member State in order to pursue their activities under the same conditions as those which apply to subsidiaries. The ECJ then observed that the definitive tax rate of 42% applicable to the profits of branches of head offices having their seat in another Member State constitutes, generally speaking, unfavourable treatment in relation to the tax rate reduced to 30%, which is applicable to the profits of the subsidiaries of such companies. As a consequence, the German rules restrict the freedom to choose the appropriate legal form

[723] The ECJ has explicitly and rightly recognized this in respect of the residence State of the shareholder which operates a system of imputation credits for the avoidance of economic double taxation: insofar as there is no double taxation, no imputation credit is required. See the cases of C-319/02 *Manninen*, Case C-292/04 *Meilicke,* Case C-446/04 *Test Claimants in the FII Group Litigation* and Case C-262/09 *Meilicke II*.

[724] Case C-253/03 *CLT-UFA*.

in which to pursue activities in another Member State. It was thus necessary to examine whether that differential treatment is objectively justified. As regards the argument that there is a fundamental difference between the distribution of profits by a subsidiary to its parent company and the transfer of profits within a company, the ECJ made the following observation:

> "In both cases the profits are made available to the company which controls the subsidiary and the branch respectively. The only real difference between the two situations lies in the fact that the distribution of the profits of a subsidiary to its parent company presupposes the existence of a formal decision to that effect, whereas the profits of a branch of a company are part of the assets of that company even in the absence of a formal decision to that effect."[725]

Subsequently, the ECJ decided that the higher tax rate for branches was discriminatory and contravened Article 49 TFEU. The ECJ would have reached a different decision if it had respected the aim of the German tax system: the mitigation of economic double taxation within groups of companies. Such economic double taxation does not occur if a branch transfers profits to its head office, but occurs only if a subsidiary makes a dividend payment. Thus, the non-applicability of the reduced tax rate to permanent establishment of a foreign head office served a perfectly respectful aim which should have been respected by the principle of free movement.

8.3.2.5 Situations where tax sovereignty and free movement respect each other

Introduction
In situations where both the principle of tax sovereignty and the principle of free movement respect each other, a process of optimization starts through proportionality analysis. Before that, however, it should be assessed whether the objective of a tax measure is also compatible with other norms of EU law (section 8.3.1.4).

The requirement of a legitimate objective compatible with EU law
This requirement is completely in line with the theoretical optimization model which requires that a rule or principle can only serve as a limit to the principle of free movement if it is formally and substantively compatible with other principles with a similar status such as those enshrined in the TEU and the TFEU (see section 7.5).

The requirement of overriding reasons in the public interest
If the objective of the restrictive tax measure is compatible with other norms of EU law and it also respects the principle of free movement, the tax measure can serve as a limit to free movement. According to the theoretical optimization model, any objective whatsoever may serve as such. The case law discussed in section 8.3.1.4 shows that the ECJ in practice accepts any policy objective as long as it respects free movement; this is

[725] Case C-253/03 *CLT-UFA*, § 23.

also reflected in the table of direct tax cases in the annex to this book.[726] So, contrary to the classic requirement that a justification ground should be 'overriding', ECJ case law allows every thinkable objective as a justification for a restriction on free movement as it is respectful towards free movement. Therefore, the present author fully agrees with Timmermans' view that there is no such thing as a general principle of EU law according to which the free movement provisions can be deemed to imply a rule of reason as to their interpretation and application.[727] They do not have a view of their own as to how Member States should design their tax systems. If this were otherwise, the free movement provisions would prescribe how Member States should organize their tax systems, which would be disrespectful.

In this light, the criticism by tax scholars of the ECJ, summarized in section 2.3, is not supported by the theoretical optimization model. In my view, it does not seem very fruitful to make lists with 'actually accepted' grounds of justification and 'in principle accepted justifications, but never in practice',[728] because the analysis of a restrictive tax measure always comes down to its objective. It must be emphasized once again that the ECJ does not 'invent' grounds of justification, but merely accepts the objective stated by the national court.[729] If it were to 'invent' grounds of justification, the principle of free movement would be disrespectful towards the principle of tax sovereignty. It also does not seem very helpful to examine why a certain ground of justification appears in one of these three lists and not in another,[730] to criticize the way the ECJ interprets a ground of justification once it has been categorized in one of the lists, or to study whether certain 'accepted' justifications are 'really' the same justification.[731] For example, an 'accepted' justification ground such as the need to maintain the cohesion of the tax system cannot be examined as if such a justification were an autonomous object of interpretation. Under the theoretical optimization model one would not state that in cases like *Manninen* and *Marks & Spencer* a "new principle of cohesion" would have been born in a "movement of cautious relaxation".[732] This does not mean that it cannot be useful to resort to some kind of categorization of similar cases (see chapter 3). When using this method a court gives clear general guidance on the application and interpretation of fundamental rights in certain categories of cases instead of engaging in a balancing exercise in individual cases. This leads to a higher degree of legal certainty. As discussed in section 4.2, the process of optimization may indeed result in specific 'rules' for certain categories of cases.

Another matter which has exercised many minds concerns the question of 'how many' justifications have to be present in order for a restriction on free movement to be justified. Should three justifications be present, or are two or even one enough?[733] Under

[726] Another good example is Case C-194/06 *Orange European Smallcap Fund NV*, where the ECJ fully accepts the objective of equal treatment of direct investment or indirect investment through an investment fund.

[727] Timmermans 2005, p vii.

[728] See for instance Roth 2008, p 79 and 94; Kingston 2007, p 1347.

[729] See Lang 2009, p 113, for an opposite view.

[730] E.g. Mason 2007, p 85.

[731] E.g. Wattel 2004, p 92; Wattel 2007 and Terra & Wattel 2008, p 373-374.

[732] Vanistendael 2005. See also Kingston 2007, p 1348-1349.

[733] Isenbaert 2009, p 274.

the theoretical optimization model such questions are irrelevant. It is the objective of the national tax measures which counts, followed of course by the other phases of the model. This is particularly apparent from the above-discussed case of *Papillon*. One of the justifications put forward by France – the need to ensure the coherence of the tax system – was reviewed by the ECJ in the light of the objective of the group consolidation regime: the neutralisation of intra-group transactions.[734] If a non-resident group company were not part of the consolidated group, it may not in all cases be possible to achieve this objective fully if the French sub-subsidiary suffers a loss. After all, that loss may be taken into account at the level of the consolidated group and also at the level of the French parent company through a write-down of the shares in the non-resident group company. Consequently, the need to ensure the coherence of that regime may serve as a justification for the restriction on freedom of establishment in the light of the objective of the group consolidation regime.

8.3.3 Future developments

On the basis of the theoretical assessment model, three developments should be expected. First, the ECJ should leave its case law on the basis of which distinctions which are directly based on the origin of the product or on the (foreign) nationality of the taxpayer can only be justified on grounds of the express Treaty derogations. Second, the ECJ should drop the formal requirement that only reasons which are 'overriding' or 'compelling' can serve as a justification for a restriction on free movement. Indeed, as the ECJ materially recognises in its case law, any principle or rule can serve as a limit to free movement, as long as its objective is respectful towards free movement. As a consequence, the only thing that matters is the objective and aim of a restrictive rule. Third, scholars could stop making lists of 'accepted' and 'accepted in principle but not in practice' and any analysis based thereon. In my view, ECJ case law nor the theoretical optimization model supports this activity. Moreover, it may result in a discourse which is too dogmatically focussed on justification grounds (section 4.4).

8.4 Suitability

8.4.1 Current ECJ case law on direct taxation

It is settled ECJ case law that for a restrictive tax measure to be justified, it must be appropriate for securing the attainment of the objective it pursues.[735] This test is not very intensive; it is decisive whether the restrictive measure is effective. In the words of Wattel and Poiares Maduro: does it make sense in the light of the stated objective?[736] Suitability presupposes a coherence between a measure and its objective and consistency in pursuit

[734] Case C-418/07 *Papillon*, § 46-51.
[735] Case C-318/07 *Persche*, § 52.
[736] Terra & Wattel 2008, p 34; Opinion AG Poiares Maduro in Joined Cases C-570/07 and C-571/07 *Blanco Pérez and Chao Gómez*, § 23 and 31.

of the objective.[737] In the vast majority of direct tax cases the restrictive measure at issue passed this test. A rare example of a restrictive direct tax rule which did not meet the requirement of suitability is provided by the case of *Orange European Smallcap Fund*. This case concerned the Dutch special corporate income tax regime for portfolio investment funds. This regime provides for (1) taxation of the fund at a rate of 0% and (2) a credit of dividend withholding tax (DWT) to the fund with regard to dividends received by the fund. It is aimed at providing equal treatment of direct portfolio investments on the one hand and indirect portfolio investments – through an intermediary investment fund – on the other. In 1997, Orange European Smallcap Fund NV (OESF) - whose shareholders resided in various (EU and non-EU) countries – had received dividends from various countries, including Portugal and Germany. These dividends had been subject to foreign DWT. OESF claimed a (substitute) credit of those foreign withholding taxes. This credit was, pursuant to Dutch legislation, restricted in two ways. Firstly, no credit of DWT was granted with regard to the dividends from Portugal and Germany, because of the non-existence (in 1997) of tax treaties between the Netherlands and those countries providing for a right to a credit of foreign DWT against Dutch income tax. Secondly, with regard to the dividends from other foreign countries, the credit of DWT was reduced in proportion to the participation in OESF by shareholders not residing in the Netherlands. OESF claimed a full credit of all foreign DWT. With respect to the above-mentioned second criterion, the ECJ held that the technical rule according to which the credit was calculated was not apt to meeting its objective, namely not to provide a tax credit with respect to shareholders in OESF which are not fully subject to the Dutch income tax jurisdiction. The ECJ noted that that objective cannot be achieved by a reduction of the tax credit to the fund in proportion to the interest in those enterprises held by shareholders resident or established in other Member States, because such a reduction adversely affects all the shareholders of fiscal investment enterprises without distinction, as it has the effect of reducing the total amount of profit for distribution. As a consequence, the rule did not meet the suitability test.[738]

Another example – at least in my view – is the case of *Bosal*.[739] In this case, the ECJ held a Netherlands rule to be contrary to freedom of establishment. Under this rule, Netherlands resident parent companies could only deduct costs relating to income from a subsidiary if the subsidiary was taxable in the Netherlands or if its costs were indirectly instrumental in the making of profits taxable in the Netherlands. The ECJ held that this rule constitutes a *prima facie* restriction on freedom of establishment (section 8.2.1.4). Subsequently, the ECJ considered that this restriction could not be justified by the need to preserve the coherence of the tax system or the principle of territoriality. In a crucial paragraph, the ECJ pointed out that "one is entitled to question the coherence of a system of taxation based on the existence of a link between costs incurred in relation to holdings and the existence of profits taxable in the Netherlands within the same group of companies, while subsidiaries of parent companies established in other Member States cannot deduct from their profits

737 Mathisen 2010, p 1037-1039.
738 Case C-194/06 *Orange European Smallcap Fund NV*, § 82.
739 Case C-168/01 *Bosal Holding BV*.

taxable in the Netherlands the costs in relation to holdings of those parent companies."[740] This shows that, for example, interest costs which are related to the acquisition of the shares in a foreign subsidiary belong – under Dutch national tax principles but also under principles of international tax law – in the tax jurisdiction of the State of the parent company. The principle of territoriality or the need to preserve a balanced allocation of taxing rights between the Member States, which are after all jurisdictional principles, cannot be attained by the allocation of these costs to another Member State. The Dutch rule was therefore, in my own words, not apt to attain the objectives pursued by it.

Exactly the same issue arose in the case of *Deutsche Shell*.[741] This case concerned the refusal of deductibility in Germany of a currency loss suffered by an Italian permanent establishment of a company resident in Germany. In 1974, Deutsche Shell GmbH had set up a branch in Italy. The proceeds generated by that branch were recorded, in accordance with Italian law, in a commercial and tax account drawn up in Italian currency and, for Deutsche Shell, in a separate German commercial and tax account. Deutsche Shell provided its branch with start-up capital, which was entered in the separate German commercial and tax account with the DEM exchange rate obtaining at the time of each payment made in LIT. In 1992, Deutsche Shell transferred the assets of the branch to an Italian subsidiary; subsequently it sold the shares in that subsidiary to an independent third party. Between 1974 and 1992 the Italian Lira had lost value against the German mark. The currency loss on the start-up capital was not taken into account in Italy, as the profits of the Italian branch were calculated in the local currency. It was not taken into account in Germany either because all results from the Italian permanent establishment were exempt from German corporation tax under the applicable bilateral tax treaty. Deutsche Shell argued that this infringed its freedom of establishment. The ECJ considered that all measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be regarded as obstacles. The non-deductibility of currency losses "increases" the economic risks incurred by a company established in one Member State wishing to set up a body in another Member State where the currency used is different from that of the State of origin. In such a situation, not only does the principal establishment face the normal risks associated with setting up such a body, but it must also face an additional risk of a fiscal nature where it provides start-up capital for it. Because Deutsche Shell exercised its freedom of establishment it suffered financial loss which was not taken into account either by the national tax authorities for the purposes of calculating the basis of assessment for corporation tax in Germany or with respect to the assessment for tax of its permanent establishment in Italy.[742] Germany argued *inter alia* that its bilateral tax treaty with Italy on the allocation of tax powers pursues a legitimate objective: Germany and Italy decided to exempt permanent establishments situated on the territory of the co-Contracting State from income tax, which excludes the currency loss concerned from being taken into account. The ECJ rejected this argument by noting "that the tax disadvantage concerned relates to a specific operational factor which is capable of being taken into consideration only by the German tax authorities. Although it is true that any Member

740 Case C-168/01 *Bosal Holding BV*, § 36.
741 Case C-293/06 *Deutsche Shell*.
742 Case C-293/06 *Deutsche Shell*, § 28-31.

State which has concluded a double taxation convention must implement it by applying its own tax law and thereby calculate the income attributable to a permanent establishment, it is unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses which, by their nature, can never be suffered by the permanent establishment."[743] In other words, the objective of allocating taxing powers between the Contracting States or the avoidance of international juridical double taxation could not be achieved by the exemption system at issue: it failed the suitability test. In this respect, *Deutsche Shell* confirms the earlier judgment of *Bosal*.

8.4.2 Relation to the theoretical optimization model

ECJ case law on direct taxation is fully in line with the theoretical optimization model. Just like the model, it is decisive whether a restrictive direct tax measure is 'capable' of actually protecting the interest that needs to be protected, meaning that there must be a causal relationship between the measure and the objective (see sections 4.5.3 and 7.5). This requires a strongly factual judgment.[744] Normally, tax measures meet this test; the test with a 'bite' in ECJ case law on direct taxation is the necessity test (in the present model: the tests of degree of fit and subsidiarity). When a direct tax measure does fall short of the requirement of suitability, fierce criticism is sometimes the result. This is particularly true for the case of *Bosal*. According to AG Geelhoed, the ECJ has not accorded sufficient recognition to the Member States' division of tax jurisdiction in that case.[745] He specifically refers to the finding of the ECJ that the comparability criterion is satisfied. It is, in AG Geelhoed's view, crucial to the analysis that the Netherlands exempted from taxation all 'inward' profits from non-domestic subsidiaries. According to the AG, the division of the tax jurisdiction between the Netherlands and the Member States of residence of the subsidiaries is such that jurisdiction to tax the foreign subsidiaries' profit fell solely on the source state. As explained above, this view is based on a misunderstanding of principles of national and international tax law. Contrary to what Wattel has stated, *Bosal* is not "in sharp contrast" with *Marks & Spencer* (Case C-446/03; see section 2.2.5),[746] because the latter case concerned operational losses which were attributable to another Member State under principles of international tax law. This was clearly not the case in *Bosal*, which was, therefore, correctly decided. Also, contrary to what Wattel has argued,[747] the currency losses in *Deutsche Shell* cannot in any way be compared with the 'final' losses in *Marks & Spencer*: these losses belong to separate tax jurisdictions – the State of the head office and the State of the subsidiary respectively – which explains the different reasoning by the ECJ.[748] In summary, ECJ case law is supported by the theoretical optimization model.

743 Case C-293/06 *Deutsche Shell*, § 44.
744 Gerards 2005, p 301.
745 Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*.
746 Terra & Wattel 2008, p 409. Compare also Weber 2003.
747 Case note P.J. Wattel in BNB 2009/86, § 9.
748 See also Douma 2010.

8.4.3 Future developments

It is expected that there will be no developments in the case law regarding the suitability test, because current ECJ case law is fully in line with the theoretical optimization model.

8.5 The degree of fit

8.5.1 Current ECJ case law on direct taxation

At present, ECJ case law in the area of direct taxation subsumes the assessment of the over- and/or underinclusiveness of a classification – the degree to which the definition of a classification matches the aim of the measure – under the necessity test (the application of a direct tax measure should not go beyond what is necessary for its purpose). In my view, the requirement of a sufficient degree of fit should be distinguished from the subsidiarity of a certain classification (section 7.6).

The case law on direct taxation shows examples of both under- and overinclusiveness. The above-discussed case of *Manninen* is a clear example of a tax rule which was underinclusive in relation to its objective.[749] Anti-abuse measures are often examples of overinclusiveness. The above-discussed case of *Cadbury Schweppes* is a clear example of this. *Thin Cap GLO* is another example of overinclusiveness.[750] This case concerned UK provisions regarding 'thin capitalization'. These provide that, in some circumstances, interest paid by a company to another company belonging to the same group in respect of a loan granted by the latter is to be treated as a distribution, thereby prohibiting the borrowing company from deducting the interest paid from its taxable profits. The rules however gave rise to a difference in treatment between resident borrowing companies according to whether or not the related lending company is established in the United Kingdom. The rules are targeted at the practice of thin capitalization, under which a group of companies will seek to reduce the taxation of profits made by one of its subsidiaries by electing to fund that subsidiary by way of loan capital, rather than equity capital, thereby allowing that subsidiary to transfer profits to a parent company in the form of interest which is deductible in the calculation of its taxable profits, and not in the form of non-deductible dividends. Where the parent company is resident in a State in which the rate of tax is lower than that which applies in the State in which its subsidiary is resident, the tax liability may thus be transferred to a State which has a lower tax rate. According to the ECJ, the different treatment on the basis of the place of residence of the lending company constitutes a restriction on freedom of establishment which can be justified on the ground of prevention of abusive practices if the specific objective of such a restriction is to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. By providing that that interest is to be treated as a distribution, such legislation is able to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken

[749] Compare also Case C-152/05 *Commission v. Germany ("Eigenheimzulage")*, § 28.
[750] The judgment in this case was confirmed in Case C-311/08 *SGI*.

in the national territory. It followed that such legislation is an appropriate means of attaining the objective underlying its adoption.[751] Finally, the ECJ examined whether or not that legislation goes beyond what is necessary to attain that objective. As so often, this proved to be the test with a 'bite'. Under this test the ECJ came to the conclusion that the UK legislation should provide for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allow taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question. Secondly, where it is established that such an arrangement exists, the UK legislation should treat that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.[752]

An awkward case in relation to the 'degree of fit' test is the case of *Sardinia*.[753] This case concerned a regional tax on stopovers imposed on operators of aircraft or recreational craft having their tax domicile outside the territory of Sardinia. This tax served an environmental purpose (the polluter pays principle). The ECJ held that, in terms of the consequences for the environment, all natural and legal persons who receive the services in question are in an objectively comparable situation with regard to that tax, irrespective of the place where they reside or are established. The fact that taxpayers in Sardinia contribute, through general taxation and, in particular, income tax, to the environmental protection activities undertaken by the Region of Sardinia, is irrelevant for the purposes of comparing the situation of residents with that of non-residents in relation to the regional tax on stopovers.[754] On these grounds, the ECJ held that the regional tax constituted both a prohibited restriction on freedom to provide services and prohibited State aid for regional undertakings – which were not subject to the tax – under Article 107(1) TFEU.

8.5.2 Relation to the theoretical optimization model

The above-discussed cases of *Cadbury Schweppes* and *Thin Cap GLO* are classic examples of the interaction between the requirement of a respectful aim and the assessment of the degree of fit of a measure. The ECJ fundamentally accepts that a State may adopt rules which prevent tax avoidance. These rules should, however, be respectful towards the principle of free movement. Insofar as they, for example, qualify as abusive the situation in which a resident company establishes a subsidiary in another Member State for the sole reason of benefitting from a tax advantage, that qualification would be disrespectful towards free movement as it would render that principle meaningless. Conversely, however, the principle of free movement should leave room to prevent conduct by taxpayers which would lead to a situation in which the taxpayer himself could decide where to pay tax. Such an interpretation of the free movement provisions would effectively deny the right of a Member State to regulate within its domestic jurisdiction (see section 7.4). This is why

751 Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, § 74-77. See extensively on this case Vleggeert 2009, p 251-265.

752 Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, § 92.

753 Case C-169/08 *Presidente del Consiglio dei Ministri v. Regione Sardegna*.

754 Case C-169/08 *Presidente del Consiglio dei Ministri v. Regione Sardegna*, § 37-38.

the ECJ considers that the artificial shifting of taxable profits from one tax jurisdiction to another would undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory. As a consequence, some middle ground has to be found between the two competing principles. The ECJ has found this in the formulation of the notion of 'wholly artificial arrangements'. After thus having reformulated the benchmark objective of the legislation,[755] it was easy to assess that the legislation was overinclusive in relation to its objective.[756]

The *Sardinia* case could, however, be at odds with the theoretical optimization model. The exemption of regional undertakings from the tax was underinclusive in relation to its environmental objectives. This underinclusiveness can only be remedied by the recovery of the advantage thus granted under Articles 107 and 108 TFEU. By holding that the taxation of non-resident operators amounted to a restriction on freedom to provide services, the ECJ arguably did not respect the environmental objectives implemented by the Region of Sardinia in the exercise of its tax sovereignty. There could be, however, another way of looking at the issue. A conflict between Article 49 TFEU (freedom of establishment) and Articles 107 and 108 TFEU (*prima facie* prohibition of State aid) may arise in situations where a certain tax measure grants an advantage to certain undertakings. In its judgment in *Belgium and Forum 187*[757], the ECJ held that in order to decide whether a certain tax measure results in an advantage, it is necessary to compare that measure with the ordinary tax system. It is therefore necessary to start by asking whether a person should have been taxed and, if so, whether the absence of taxation constitutes an advantage.[758] In the case of *Sardinia*, the exemption of domestic operators of aircraft or recreational craft constituted such an advantage, because, in terms of the consequences for the environment, all natural and legal persons who receive the services in question are in an objectively comparable situation with regard to the tax on stopovers, irrespective of the place where they reside or are established. In other words, domestic operators should have been taxable in the light of the environmental objective of the tax. The exemption from tax constitutes an advantage covered by Article 107 TFEU and a corresponding disadvantage to non-resident operators covered by freedom to provide services. In case of such a conflict between Article 107 TFEU and the free movement provisions, Article 107 TFEU in principle prevails. The ECJ has held that aid referred to in Article 107 and 108 TFEU do not as such fall within the field of application of the four freedoms. Only those aspects of the aid which are not necessary for the attainment of its object or for its proper functioning and which contravene the provisions of the four freedoms may for that reason be held to be incompatible with the relevant freedom.[759] In the case of *Sardinia*, the conflict between Article 107 TFEU and the free movement provisions has, therefore, been resolved in favour of Article 107 TFEU. Insofar as no conflict arose, however, – this was the case to the extent that other persons

[755] In my view, such a reformulation is acceptable, because it leaves the core of the objective intact and only removes the disrespectful elements.

[756] The question of how precise the degree of fit should be depends on the objective of the tax measure and and the intensity of review enabled by this objective (see section 7.2).

[757] Joined Cases C−182/03 and C−217/03, § 95.

[758] Opinion AG Jääskinen in Joined Cases C−106/09 P and C−107/09 P *Commission and Spain v Gibraltar and United Kingdom*, §165.

[759] Case 74/76 *Ianelli and Volpi*, §17. See also Case C-94/99 *ARGE Gewässerschutz*, § 36.

than undertakings meant in Article 107 TFEU were affected by the tax – the freedom to provide services could still be applied. Apparently, the ECJ held that to this extent the principle of free movement should outweigh the need to prevent pollution.

8.5.3 Future developments

It has been shown in the preceding sections that ECJ case law does not differ from a practical point of view from the theoretical optimization model. However, it would be desirable for the ECJ to distinguish in its future case law between the assessment of the degree of fit of a measure and the requirement of subsidiarity. The over- or underinclusiveness of a measure signifies that the goal could have been achieved by choosing a more careful or more finely tuned definition (section 7.6). The requirement of subsidiarity, however, does not so much address the way in which the classification is defined, but relates to the choice of the classification as a means to achieve the intended goal. In my view, at least in direct taxation cases, this is a much more politically sensitive exercise. As the ECJ has been accused of failing to appreciate the sovereignty which Member States have retained in the area of direct taxation – see section 2.2.5 – it could be advisable to distinguish between the more 'mechanical' and more 'political' exercises which may encroach upon national policy choices (see section 7.7).

8.6 Subsidiarity

8.6.1 Current ECJ case law on direct taxation

The best-known examples of cases in which the subsidiarity test is applied by the ECJ concern direct tax measures which are in place because of an alleged lack of fiscal supervision in cross-border situations. This lack would justify a more burdensome taxation or would justify a reverse burden of proof. In intra-EU situations the ECJ normally counters these arguments by reference to Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15; 'Directive 77/799'), which enables tax authorities to call upon the authorities of another Member State in order to obtain all the information that may be necessary to effect a correct assessment of a taxpayer's liability to tax. That directive provides, with a view to preventing tax evasion, for the possibility of national tax authorities requesting information which they cannot obtain for themselves.[760] Thus, there are other measures available which enable the Member States to achieve the prevention of tax avoidance.[761]

[760] Case C-318/06 *Persche*, § 61.

[761] Case C-55/98 *Vestergaard*, § 28. In cases where Directive 77/799 does not apply, the subsidiarity test is performed by examining whether the national tax authorities are able to verify the necessary information by other means e.g. by information exchange clauses in tax treaties; compare Case C-101/05 *A* and Joined Cases C-155/08 and C-157/08 *X and Passenheim-van Schoot*. Case C-72/09 *Rimbaud* is at odds with these principles, because the ECJ ruled out the possibility for a taxpayer to provide evidence through other means. This poorly motivated ruling is dubious in view of the theoretical optimization model, because it fails to accept that the same

Case C-436/00 *X&Y* is another example of the application of the subsidiarity test. This case concerned Swedish tax rules which made it impossible to defer Swedish income taxation on unrealized gains on shares if the recipient company – in which the transferor has a substantial interest – is directly or indirectly resident in another Member State, whereas such deferment was possible if the recipient company is a resident of Sweden. The ECJ held that this different treatment constitutes a *prima facie* restriction on freedom of establishment or free movement of capital (Articles 49 and 63 TFEU). Sweden argued, *inter alia*, that taxation of the unrealized gain was necessary in view of maintaining the coherence of the tax system which would be jeopardized by the fact that the tax base is liable to disappear at a subsequent stage following a definitive move abroad by the taxpayer. The ECJ however held that "the coherence of the tax system can be safeguarded by measures which are less restrictive or less prejudicial to freedom of establishment, relating specifically to the risk of a definitive departure of the taxpayer (…). De telles mesures pourraient, par exemple, consister à prévoir un régime de cautionnement ou d'autres garanties nécessaires afin d'assurer le paiement de l'impôt lors d'un déménagement définitif du cédant à l'étranger."[762] In other words, an immediate taxation of the unrealized capital gain upon the transfer of the shares to a related company is not the most subsidiary means to maintain the Swedish tax claim on that unrealized gain. There are other measures available, such as the introduction of a requirement to provide a guarantee to the State for the tax due on the unrealized gain.

In the earlier case of *Bachmann*, the ECJ also applied the subsidiarity test.[763] This case concerned Mr. Bachmann, a German national employed in Belgium. The Belgian tax administration had refused to allow the deduction of contributions paid in Germany pursuant to sickness and invalidity insurance contracts and a life assurance contract concluded prior to his arrival in Belgium. The ECJ held that this non-deductibility amounts to a *prima facie* restriction on free movement of workers. It noted that workers who have carried on an occupation in one Member State and who are subsequently employed, or seek employment, in another Member State will normally have concluded their pension and life assurance contracts or invalidity and sickness insurance contracts with insurers established in the first State. It followed that there is a risk that the Belgian provisions may operate to the particular detriment of those workers who are, as a general rule, nationals of other Member States.[764] Subsequently, the ECJ considered that this restriction may be justified on grounds of coherence of the tax system.[765] Under the Belgian rules there exists a connection between the deductibility of contributions and the liability to tax of sums payable by the insurers under pension and life assurance contracts: pensions and payments under life assurance contracts are exempt from tax where there has been no deduction of contributions. The cohesion of such a tax system presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid

objective – fiscal supervision – could have been achieved by putting a burden of proof on the taxpayer.

762 Case C-436/00 *X&Y*, § 59. The last sentence is missing in the English version. Therefore, the French text is quoted.

763 Case C-204/90 *Bachmann*. See also Case C-300/90 *Commission v. Belgium*.

764 Case C-204/90 *Bachmann*, § 9.

765 Case C-204/90 *Bachmann*, § 21-28.

in another Member State, it should be able to tax sums payable by insurers. According to the ECJ, this aim could not be achieved by Belgium by less burdensome means such as an undertaking by an insurer to pay such tax (enforcement problems) or the deposit by the insurer of a guarantee (additional expense passed on in the insurance premiums, with the result that the insured would cease to have any interest in maintaining them). Wattel has argued that the ECJ has failed to mention the possibility of requiring a guarantee upon emigration of the employee from Belgium, as it did in X&Y.[766] This does not mean, however, that the ECJ did not apply the subsidiarity test.

This test was also followed in *Commission v. Belgium*, a case concerning Belgian withholding tax (discussed in 8.2.1.5 above). The Belgian government had argued that the withholding of tax on a certain payment was aimed at combating tax fraud and at ensuring that tax liability in Belgium cannot be escaped. As regards the withholding obligation, the ECJ held that "a less restrictive means than that of depriving service providers of a not inconsiderable portion of their earnings would have been to put in place a system, based on an exchange of information between principals and contractors, their contracting partners and the Belgian tax authorities, allowing, for example, principals and contractors to find out about any tax debts of their contracting partners or introducing an obligation to inform the Belgian tax authorities of any contract concluded with unregistered contracting partners or any payment made to them."[767]

Both *X&Y* and *Commission v. Belgium* are clear examples of the application of a subsidiarity test.[768] Case C-414/06 *Lidl Belgium* is a case where the ECJ could have applied a subsidiarity test but explicitly chose not to do so. Lidl Belgium GmbH, a company resident in Germany, had a permanent establishment in Luxembourg. In 1999, Lidl Belgium's permanent establishment in Luxembourg incurred a loss. When calculating its revenue for German tax purposes, Lidl Belgium sought to deduct that loss from the amount of its tax base. The German tax authorities disallowed the deduction of that loss on the basis, *inter alia*, of the exemption of income relating to that permanent establishment by virtue of the provisions of the tax treaty between Germany and Luxembourg. According to AG Sharpston, this disallowance amounts to a restriction on freedom of establishment because a domestic loss would have been deductible from the tax base. This restriction is however capable of being justified on grounds of its objectives of preserving the balanced allocation of the power to impose taxes between Germany and Luxembourg and of avoiding the danger that losses would be used twice. In view of the AG, the principle of proportionality is however not respected by the non-deductibility of the Luxembourg loss:

> "23. It is, moreover, clear that less restrictive measures are possible. It is common ground that, prior to 1999, German legislation expressly provided that a company could deduct a loss made by a permanent establishment in another Member State to the extent to which it exceeded profits made by the permanent establishment and subject to the deduction being brought back into account in subsequent years in which the permanent establishment made a profit.

[766] Terra & Wattel 2008, p 384. In Case C-422/01 *Skandia* and Case C-150/04 *Commission v. Denmark*, the ECJ not accept the cohesion justification.

[767] Case C-433/04 *Commission v. Belgium*, § 39.

[768] See also Case C-118/96 *Safir*, § 33.

> 24. Such a rule, which allowed the deduction of losses while providing for the recapture of the loss relief in future profitable periods, would manifestly be a less restrictive means of avoiding the risk that losses might be used twice than a rule altogether excluding relief for such losses. Although a deduction-and-recapture rule involves a loss of symmetry and hence does not wholly attain the objective of the balanced allocation of the power to tax, that asymmetry is merely temporary where the permanent establishment subsequently becomes profitable. Moreover provision could be made for automatic reincorporation of amounts previously deducted if reincorporation had still not occurred after, for example, five years, or if the permanent establishment ceased to exist in that form.
> 25. Such a deduction-and-recapture rule is unarguably less restrictive of the taxpayer's fundamental right of establishment than an outright prohibition of deducting from the profits of a company losses made by a permanent establishment in another Member State. At the same time it is still appropriate for attaining the objectives of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses would be used twice."

The ECJ disagreed with this analysis, but did not explain on which points the AG's analysis is incorrect. It held that freedom of establishment does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods.[769]

8.6.2 Relation to the theoretical optimization model

The requirement of subsidiarity does not so much address the way in which the classification is defined, but relates to the choice of the classification as a means of achieving the intended goal. Although the above-discussed cases of *X&Y*, *Bachmann* and *Commission v. Belgium* clearly show that the ECJ is prepared to perform this test, *Lidl Belgium* proves that the ECJ is also aware of the political sensitivity of this test in cases where the alternative measure is not provided by an EU instrument such as Directive 77/799. This is also reflected by the non-tax case of *Fedesa*.[770] This case concerned the validity of a directive requiring Member States to introduce a prohibition on the use in livestock farming of certain substances having a hormonal action. Fedesa argued that the measures of the directive infringed the principle of proportionality. The ECJ held:

[769] The ECJ has extended this line of reasoning to systems of full tax consolidation which make it possible to treat a subsidiary as tax transparent (i.e. a permanent establishment) in the sense that foreign losses do not have to be accepted by the State of the parent company; see Case C-337/08 *X Holding*.

[770] Case 331/88 *Fedesa*. See on this case Jans *et al.* 2007, p 150.

> "13. The Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued.
> 14. However, with regard to judicial review of compliance with those conditions it must be stated that in matters concerning the common agricultural policy the Community legislature has a discretionary power which corresponds to the political responsibilities given to it by Articles 40 and 43 of the Treaty. Consequently, the legality of a measure adopted in that sphere can be affected only if the measure is *manifestly inappropriate* having regard to the objective which the competent institution is seeking to pursue (…)."[771]

By the use of the term 'manifestly inappropriate' – which could also be applied under the suitability test – the ECJ shows that it is fully aware of its constitutional position by not conducting a full and intensive review in matters concerning Union legislation.[772] When assessing national measures, the ECJ seems to take a much stricter approach.[773] It is debatable whether the ECJ should introduce some variation in the intensity of review of national measures and free movement in this respect. Indeed, as Gerards has shown, there a good arguments for such an approach in general.[774] I have however decided not to formally include such a preliminary phase for the purposes of the present study (section 7.2). Regardless of this debate, *Lidl Belgium* was in my view still wrongly decided. Clearly, the objective of avoiding international juridical double taxation could have been achieved in the way proposed by the AG in *Lidl Belgium*. This is underlined by the fact that the Commentary to the OECD Model Tax Convention explicitly gives the State of residence a choice between two equally allowable exemption methods: 'full exemption' (loss not taken into account) or 'exemption with progression' (loss temporality taken into account).[775] Thus, the decision in *Lidl Belgium* is at odds with the theoretical optimization model. It is a wrong decision because the ECJ failed to achieve the optimum position between two competing principles: the position of free movement – which suffered a major set-back because of the German exemption system – could have been improved without detriment to tax sovereignty (the requirement of Pareto-optimality; see section 7.7). The same is true for the case of *X Holding*. The ECJ could have applied the Dutch full tax consolidation system cross-border without jeopardizing the allocation of taxing powers under the Dutch tax treaties by applying rules for the avoidance of double taxation for permanent

771 Case 331/88 *Fedesa*, § 13.
772 Gerards 2008, p 681-682.
773 Harbo 2010, p 172.
774 Gerards 2011.
775 OECD Commentary to the OECD Model Tax Convention on Income and on Capital, Articles 23A and B, § 14 and 44.

establishments (the objective of the Dutch system was to give parent companies the option to treat their subsidiaries as tax transparent or as 'branches' of themselves).[776] This would have been in accordance with settled Dutch Supreme Court case law.[777] Instead, the ECJ chose to ignore the objectives of the Dutch fiscal unity system and the Dutch tax treaties.[778] In this way, the principle of free movement was applied in a disrespectful way (compare section 8.3.2.4).

8.6.3 Future developments

It would be desirable for the ECJ to distinguish in its future case law between the assessment of the degree of fit of a measure and the requirement of subsidiarity (section 8.4.3). In other words, it would be advisable for the ECJ to distinguish between more 'technical' and more 'political' exercises. This would help to explain cases like *Lidl Belgium* (although the decision would ultimately still be wrong) and it should be expected on the basis of the theoretical optimization model.

8.7 Proportionality stricto sensu

8.7.1 Current ECJ case law on direct taxation

According to established ECJ case law in the area of direct taxation, national measures which are liable to hinder the exercise of fundamental freedoms guaranteed by the TFEU or make them less attractive may be allowed only if they pursue a legitimate objective in the public interest and if they

i) are appropriate to ensuring the attainment of that objective, and
ii) do not go beyond what is necessary to attain it.[779]

ECJ case law in other areas than direct taxation shows that the principle of proportionality also has a third element:

iii) the burden caused by the national measure should not be disproportionate in relation to its objective (proportionality *stricto sensu*).[780]

If the ECJ reviews EU legislation in the light of the principle of proportionality it balances individual interests against the general interest of the Union as a whole.[781] The leading

[776] See for an extensive analysis Douma & Naumburg 2006, § 5.
[777] HR 29 June 1988, No. 24.738, BNB 1988/331, HR 13 November 1996, No. 31.008, BNB 1998/47; and HR 20 December 2002, No. 37.073, BNB 2003/286.
[778] Case C-337/08 *X Holding,* § 31 *et seq.*
[779] Case C-470/04 *N*, § 40.
[780] Case T-125/96 *Boehringer*, § 102; Opinion AG Poiares Maduro in Case C-434/04 *Ahokainen and Lepik*, § 23-26; Jans *et al.* 2007, p 149.
[781] Tridimas 2005, p 112. Also in respect of Community sanctions an individual interest is balanced against a general interest; see Case C-262/99 *Louloudakis*, § 67, and Case T-77/92 *Parker Pen*, § 92.

case in this area is *Fedesa*, already discussed above.[782] This case concerned the validity of a directive requiring Member States to introduce a prohibition on the use in livestock farming of certain substances having a hormonal action. Fedesa argued that the measures of the directive infringed the principle of proportionality. The ECJ held:

> "The Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, *and the disadvantages caused must not be disproportionate to the aims pursued*."[783]

If the ECJ reviews national legislation in the light of the free movement provisions and the principle of proportionality, it balances national interests against the interest of the Union. There are not many examples where the ECJ applies the principle of proportionality *stricto sensu* in the sphere of free movement. Most of them can be found in the area of free movement of goods. In the *Stoke-on-Trent* case the ECJ described that principle as follows: "[a]ppraising the proportionality of national rules which pursue a legitimate aim under Community law involves weighing the national interest in attaining that aim against the Community interest in ensuring the free movement of goods."[784] *Schmidberger* is another example. This company was a German international transport undertaking. It brought an action before an Austrian court seeking damages against the Republic of Austria on the basis that it had tacitly agreed to allow a demonstration on the Brenner motorway, as a result of which no traffic was possible for almost 30 hours. Austria invoked Articles 10 and 11 of the European Convention on Human Rights (freedom of speech and assembly) in order to justify the restriction on free movement of goods. The ECJ held:

> "78. First, whilst the free movement of goods constitutes one of the fundamental principles in the scheme of the Treaty, it may, in certain circumstances, be subject to restrictions for the reasons laid down in Article 36 of that Treaty [now: Article 36 TFEU] or for overriding requirements relating to the public interest (…).
> 79. Second, whilst the fundamental rights at issue in the main proceedings are expressly recognized by the ECHR and constitute the fundamental pillars of a democratic society, it nevertheless follows from the express wording of paragraph 2 of Articles 10 and 11 of the Convention that freedom of expression and freedom of assembly are also subject to certain limitations justified by objectives in the public interest, in so far as those derogations are in accordance with the law, motivated by one or more of the legitimate aims under those provisions and necessary in a democratic society, that is to say justified by a pressing social need and, in particular, proportionate to the legitimate aim pursued (…).

[782] Case C-331/88 *Fedesa*. See on this case Jans *et al.* 2007, p 150.
[783] Case C-331/88 *Fedesa*, § 13.
[784] Case C-169/91 *Stoke-on-Trent*, § 15.

> 80. Thus, unlike other fundamental rights enshrined in that Convention, such as the right to life or the prohibition of torture and inhuman or degrading treatment or punishment, which admit of no restriction, neither the freedom of expression nor the freedom of assembly guaranteed by the ECHR appears to be absolute but must be viewed in relation to its social purpose. Consequently, the exercise of those rights may be restricted, provided that the restrictions in fact correspond to objectives of general interest and do not, taking account of the aim of the restrictions, constitute disproportionate and unacceptable interference, impairing the very substance of the rights guaranteed (…).
> 81. In those circumstances, the interests involved must be weighed having regard to all the circumstances of the case in order to determine whether a fair balance was struck between those interests.
> 82. The competent authorities enjoy a wide margin of discretion in that regard. Nevertheless, it is necessary to determine whether the restrictions placed upon intra-Community trade are proportionate in the light of the legitimate objective pursued, namely, in the present case, the protection of fundamental rights."[785]

According to AG Poiares Maduro, the EU law principle of proportionality indeed consists of three sub-tests. The AG expresses the third test or 'proportionality *stricto* sensu' as the following rule: "the greater the degree of detriment to the principle of free movement of goods, the greater must be the importance of satisfying the public interest on which the Member State relies." Thus, "the Member State must demonstrate that the level of protection it decides to afford to its legitimate interests is commensurate with the degree of interference this causes in intra-Community trade." AG Poiares Maduro explains that the difference with the necessity test is that, as a result of the third test, "a Member State may be required to adopt a measure that is less restrictive of intra-Community trade, *even if this would lead to a lower level of protection of its legitimate interests*."[786] As a result, this balancing exercise prevents a Member State from fully realizing legitimate objectives of national legislation, whereas the requirements of degree of fit and subsidiarity do allow this.

Although the ECJ has never applied the principle of proportionality *stricto sensu* explicitly to direct taxation, there are at least two cases in which the ECJ arguably applied it.[787]

The above-discussed judgment in Case C-446/03 *Marks & Spencer* is a first example. To recapitulate, Marks and Spencer was a UK-based group with subsidiaries in several Member States. The continental European subsidiaries (in Belgium, France and Germany) became loss-making during the 1990s. UK-resident Marks & Spencer plc sought to offset these losses against the profits derived in the United Kingdom. As the UK group relief system only allowed for the surrender of losses from UK-resident companies or non-resident companies carrying on trade in the United Kingdom via a permanent establishment (PE), Marks & Spencer plc was denied the offset of the losses incurred in

[785] Case C-112/00 *Schmidberger*.
[786] Opinion AG Poiares Maduro in Case C-434/04 *Ahokainen and Lepik*, § 26.
[787] See for an extensive discussion Douma 2007.

the non-resident subsidiaries. As explained before, the ECJ decided that this constitutes a *prima facie* restriction on freedom of establishment. In deciding whether or not the UK restriction could be justified, the ECJ stated that it is necessary to analyze what the consequences would be if the domestic advantage, i.e. the loss surrender, were to be *extended unconditionally*. This statement forms the basis for the subsequent analysis. In this framework, the ECJ considered three justification arguments. First, according to the ECJ, the need to preserve a balanced allocation of taxing powers between the Member States could make it necessary to apply to the economic activities of companies established in one of those Member States only the tax rules of that Member State for both profits and losses. Second, the ECJ accepted that Member States must be able to prevent losses from being used twice. A double use of losses would occur if the losses of a foreign subsidiary could be used both in the subsidiary's Member State and in the parent's. Third, the ECJ stated that the risk that "losses will be transferred to companies established in the Member States which apply the highest rates of taxation" is acceptable in restricting the UK system. The ECJ held that "in the light of those three justifications taken together" the restriction in the UK system was justified. However, turning to proportionality analysis, the ECJ finally held that the preservation of a balanced allocation of taxing rights, the prevention of the double use of losses and tax avoidance could be attained by less restrictive measures. This was to accept losses from a non-resident subsidiary if the possibilities of using the losses had been exhausted in the subsidiary's Member State and the parent demonstrated this. This is remarkable, because the requirement to accept a loss under certain conditions means that this loss is transferred from one tax jurisdiction to another, which infringes a legitimate policy objective of the UK system, namely to preserve a balanced allocation of taxing powers between the Member States.

A second example is provided by the ECJ judgment in the *N*-case.[788] The *N*-case concerned the Dutch taxation of latent increases in value of shares, the taxable event being the transfer of the residence of a taxpayer, with a 'substantial holding' in a company, outside the Netherlands. It was possible to benefit from suspension of payment until the disposal of the shares, subject to conditions, such as the provision of guarantees. In addition, decreases in value occurring after the transfer of residence were not taken into account in order to reduce the tax debt. The ECJ considered that the 'exit tax' at issue is in itself in accordance with the fiscal jurisdictional principle of territoriality. Nevertheless, the ECJ went on to examine whether such a measure goes beyond what is necessary to attain the objective it pursues. It concluded that in order to be regarded as proportionate to the objective pursued, such a system for recovering tax on the income from securities would have to take full account of reductions in value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State. One can recognize a parallel here with *Marks & Spencer*, since losses suffered outside a State's direct tax jurisdiction should be taken into account under certain conditions.[789] Clearly, this infringes the previously accepted legitimate aim of the Dutch tax system, namely to adhere to the fiscal principle of territoriality.

[788] Case C-470/04 *N*.

[789] Case C-446/03, *Marks & Spencer,* § 55.

In my view, both *Marks & Spencer* and *N* are the result of a balancing exercise between national tax sovereignty and the interests of the internal market.[790] This is confirmed by AG Kokott's Opinion in the above-discussed case of *Oy AA*, which concerned the non-deductibility of a group contribution to a non-resident parent company. To begin with, the AG stated:

> "A restriction on freedom of establishment is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it. It must also be proportionate within the narrower meaning of that term."

The AG then observed that restricting the deductibility of intra-group transfers to transfers to Finnish companies is apt to safeguard the allocation of powers to impose taxes between Member States, to exclude the possibility that income which is transferred is not taxed, and to combat tax avoidance. It ensures that profits earned by group companies in Finland are subject to taxation there according to the principle of territoriality. It remained to be considered whether the provision does not go beyond what is necessary and proportionate (within the narrower meaning of that term) to achieve these purposes. Here the AG considered:

> "67. If the only issues were to ensure that transferred income was taxed and to prevent tax avoidance, the general restriction on deductibility of intra-group transfers to transfers to Finnish companies would go too far. Specifically, these two purposes could also be achieved by a rule which was less restrictive of freedom of establishment. As already explained, one might make the deductibility for tax purposes of an intra-group transfer conditional on proof that the income was in fact taxed in the hands of the recipient company.
> 68. However, safeguarding the allocation of powers to impose taxes, which is directly connected to the other two grounds of justification, could not be achieved by a corresponding, less restrictive national provision. A rule which required the State in which the transferor company was resident to allow a deduction provided that the transferee was taxed would not preclude a transfer of the power to impose taxes.
> 69. Weighing up the various interests, it also appears that a provision such as is laid down by the Finnish Law on Intra-group Financial Transfers is proportionate within the narrower meaning of that term.
> 70. In Marks & Spencer, the Court regarded it as disproportionate not to recognize a cross-border transfer of losses in a particular, exceptional situation which arose in that case, namely where the non-resident subsidiary had exhausted all possibilities of utilizing its losses and the losses could not be taken into account in the future either. In those circumstances the interest in safeguarding the allocation of powers

[790] See Douma 2007.

> to impose taxes was outweighed by freedom of establishment, and the transfer of losses to the non-resident parent company had to be allowed.
> 71. However, on the information the reference for a preliminary ruling gives as to the facts, it does not appear that Oy AA is in an exceptional situation corresponding to that in Marks & Spencer. It follows that there is no cause to consider whether, by way of exception, the principle of proportionality requires a divergence from the allocation of powers to impose taxes."

On these grounds, it seems that the ECJ is prepared to apply the principle of proportionality *stricto sensu* also in direct taxation cases.

8.7.2 Relation to the theoretical optimization model

It follows from the discussion in section 8.7.1 that ECJ case law on direct taxation is in line with – or at least not contrary to – the theoretical assessment model (see section 7.8). Ghosh and Wattel are however prominent critics of the ECJ when it comes to the performance of this test.[791] The ECJ would have no competence to decide under what circumstances a certain loss of a foreign subsidiary should be transplanted from one tax jurisdiction to another. Wattel has coined the term of 'the-always-somewhere-principle' which the ECJ allegedly observes in direct tax cases – a tax loss or deduction should be able to be deducted somewhere in the Union – but for which there would be no basis whatsoever in EU law.[792] Similarly, Ghosh has accused the ECJ of requiring that a Member State exercises tax jurisdiction where it has explicitly chosen not to do so: the foreign subsidiaries of Marks & Spencer were fully outside the UK's tax jurisdiction. To require that a tax loss of these subsidiaries should nevertheless under circumstances be transferred to the UK amounts to *positive* integration by the ECJ, according to Ghosh. The ECJ – being a court and not a legislator – would not be competent to formulate positive legislation under the guise of the fundamental freedoms.[793] Clearly, these views are not supported by the theoretical optimization model.

8.7.3 Future developments

On the basis of the theoretical assessment model it can be expected that the ECJ will not refrain from examining direct tax rules in the light of proportionality *stricto sensu* in the future. In any case, the ECJ would not be overstepping its competence if it would do so.

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791 See the discussion in section 2.4 with references to Ghosh 2007, p 81 *et seq*; Terra & Wattel 2008, p 350-351.

792 Opinion AG Wattel before HR 22 December 2006, No. 39258, BNB 2007/134, § 3.2; Terra & Wattel 2008, p 350-351.

793 Ghosh 2007, p 93-94.

8.8 Conclusion

It has been examined in this chapter how the ECJ decides tax cases at present, how this practice fits into the theoretical optimization model and, to the extent that ECJ case law is insufficient to draw conclusions on the ECJ's stance on the model in direct taxation cases in certain situations, proposals have been made on how the ECJ should decide these situations.

In respect of the first phase of the optimization model – the identification of a disadvantage – ECJ case law on disparities is in conformity with the model: in these cases there is no 'disadvantage' which can be optimized in the model (there is no conflict between two principles; see *Gilly* and *Schempp*). In respect of international juridical double taxation, the absence of rules for the avoidance of such double taxation amounts to an identifiable 'disadvantage' under phase 1 of the model. The end result is however in line with ECJ case law, because it would be a disrespectful application of the principle of free movement if a Member State were to be forced to relieve international juridical double taxation (such an obligation would deny the core aspect of the principle of tax sovereignty that a State is free to tax income within its jurisdiction in the way it sees fit; compare *Kerckhaert & Morres*). In respect of the concept of discrimination on grounds of the legal form of an establishment, ECJ case law is in conformity with the model: in these cases the disadvantage is related to the tax treatment of the other legal form (*CLT-UFA*). In respect of the concept of discrimination against cross-border activity, there is *in form* a difference between the theoretical optimization model and the ECJ's approach in direct tax cases. The ECJ formally employs a threshold criterion (a comparability test) in many direct tax cases before proportionality analysis can be performed. In fact, however, the ECJ uses a disadvantage test: a rule which taxes cross-border activity at a higher level than domestic activity constitutes a *prima facie* restriction on free movement. It is only after this has been established that the ECJ examines whether the two situations are objectively comparable (*X Holding*). This question must be answered in light of the object and purpose of the measure under consideration. This means that under current ECJ case law, a tax disadvantage must be able to be explained by the (legitimate) object and purpose of the measure under consideration. This comes very close to the theoretical optimization model (phase 2: the requirement of a respectful aim). It is therefore not surprising that there is – apart from cases like *Columbus Container Services* and *D* – not much ECJ case law on direct taxation which directly contravenes the theoretical assessment model as far as the scope of the free movement provisions is concerned. This is also true in respect of situations of 'dislocation' or 'fragmentation' of the tax base which the ECJ does not distinguish from the concept of discrimination (*Bosal*, *Manninen*, *Marks & Spencer*). In respect of non-discriminatory tax obstacles to free movement, ECJ case law neither expressly confirms nor rejects the 'disadvantage' test of the theoretical optimization model (*Commission v. Belgium*, *Deutsche Shell*). It should be expected, however, that the ECJ will move in this direction, also because ECJ case law outside the area of direct taxation points in this direction.

The second phase of the theoretical optimization model requires that the tax measure which leads to a 'disadvantage' has a 'respectful aim' and that the EU free movement provision which affects this tax measure is also respectful towards the principle of tax

sovereignty. This means that direct tax measures should *in abstracto* 'accept' that they may be limited by the principle of free movement. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. No other requirements may be imposed, apart from being formally and substantively compatible with other principles enshrined in the TEU and the TFEU. ECJ case law in the area of direct taxation states that a restriction on free movement can be justified if either an express Treaty derogation applies or the tax measure at issue pursues a 'legitimate objective which is compatible with EU law' (this reflects the model's requirement of compatibility with other principles) and is 'justified by overriding reasons in the public interest'. Thus, a correct assessment of the objective of a tax measure is of the utmost importance under the theoretical optimization model. In line with this model, ECJ case law states that the objective of a national measure may be inferred *inter alia* from its legislative history and its effects (*Finalarte*). If a national measure pursues various objectives at the same time, one of which cannot be regarded as respectful, the other respectful measure may 'save' the measure (*Campus Oil*, *Nertsvoederfabriek*). This is also in line with the model. Once the objectives of a national tax measure are clear, it can be examined whether these are 'legitimate and compatible with EU law' and are 'justified by overriding reasons in the public interest'. According to settled ECJ case law, (tax) measures which discriminate directly on grounds of nationality cannot be justified unless a specification Treaty derogation applies (*Royal Bank of Scotland*). This is problematic in view of the theoretical optimization model: no principle can be absolute and any other rule or principle should be able to serve as its limit. Of course, a distinction directly on grounds of nationality may be subject to an intense review of the degree of fit of the measure, but an outright prohibition of such a distinction is not in line with the model. Tax measures which do not meet the ECJ's requirement that a restrictive tax measure has to pursue an objective which is 'legitimate' include budgetary reasons, protection of the tax base, the existence of other tax advantages to compensate for the alleged tax disadvantage, the availability of an alternative legal or business form and the lack of EU harmonization concerning the impugned national tax measure. This can be explained by the theoretical optimization model, because the national tax measure disrespects the principle of free movement in these examples. ECJ case law also contains examples of situations where the principle of free movement is disrespectful towards the principle of tax sovereignty. A prohibition of taxation *as such* would, for example, be disrespectful (*Viacom Outdoor*, *Gilly*). It would also be disrespectful if the principle of free movement were to deprive the Member States of the possibility to determine the organization and aims of the tax system within their domestic jurisdiction (*Cadbury Schweppes*, *Oy AA*, *Test Claimants in the Thin Cap Group litigation*). If the objectives pursued by the national tax measures are misinterpreted or disrespected, bad case law is the result. Examples include *Fokus Bank*, *Amurta,* and *CLT-UFA*. In the vast majority of cases the ECJ however makes a correct assessment of the objectives of a national tax measure. If these objectives are compatible with other norms of EU law and also respect the principle of free movement, the tax measure can serve as a limit to free movement. According to the theoretical optimization model, any objective whatsoever may serve as such. ECJ case law is in line with the model in this respect. Contrary to the classic requirement that a justification ground should be

'overriding', ECJ case law allows every thinkable objective as a justification for a restriction on free movement as long it is respectful towards free movement (*Orange European Smallcap Fund*).

The third phase of the theoretical optimization model requires that the national tax measures be suitable to achieve their objectives. ECJ case law is in line with this test, where it requires that for a restrictive tax measure to be justified, it must be appropriate for securing the attainment of the objective it pursues. Two cases where this test was not met apparently include *Bosal* and *Deutsche Shell*.

The fourth phase of the theoretical optimization model examines whether the national tax measure has a sufficient degree of fit in relation to its objective. At present, ECJ case law subsumes the assessment of the over- and/or underinclusiveness of a classification – the degree to which the definition of a classification matches the aim of the measure – under the necessity test (the application of a direct tax measure should not go beyond what is necessary for its purpose). Under the model, the requirement of a sufficient degree of fit should be distinguished from the subsidiarity of a certain classification (phase 5 of the model). Examples of underinclusiveness include *Manninen* and *Sardinia*. Examples of overinclusiveness include *Cadbury Schweppes* and *Test Claimants in the Thin Cap Group litigation*.

The fifth phase of the theoretical optimization model assesses whether the national tax measure reflects the most subsidiary means to achieve its objective. Would other, less restrictive measures have been available? The best-known examples of cases in which the subsidiarity test is applied by the ECJ concern direct tax measures which are in place because of an alleged lack of fiscal supervision in cross-border situations. This lack would justify a more burdensome taxation or would justify a reverse burden of proof. In intra-EU situations the ECJ normally counters these arguments by reference to Council Directive 77/799 which enables tax authorities to call upon the authorities of another Member State in order to obtain all the information that may be necessary to effect a correct assessment of a taxpayer's liability to tax. Thus, there are other measures available which enable the Member States to achieve the prevention of tax avoidance. Other examples of application of this test include *X&Y*, *Bachmann* and *Commission v. Belgium*. The case of *Lidl Belgium* shows that the ECJ is aware of the higher political sensitivity of the subsidiarity test in comparison with the requirement of a sufficient degree of fit. In this case, the ECJ should have decided that the objective of avoiding international juridical double taxation could have been achieved by less restrictive means as indicated by the Commentaries to the OECD Model Tax Convention. Also in *X Holding* the subsidiarity test was misapplied.

The sixth phase of the theoretical assessment model contains the requirement of proportionality in the narrow sense of the term: the disadvantage caused by the direct tax measure should not be disproportionate in relation to the interests of the internal market. It is a balancing exercise between national interests and interests of the Union. Although the ECJ has not explicitly applied this test in its direct tax case law, there is clear evidence in case law such as *Marks & Spencer* and *N* that the ECJ has used it in practice to avoid black-and-white consequences of restrictive measures which are, in principle, justified. This is completely in line with the theoretical assessment model. The often-heard complaint that the ECJ has overstepped its competence in this respect is, therefore, unjustified.

Part IV:

Conclusions

9. Summary and conclusions

In the first chapter to this study, I have explained why it was in my view necessary to write this book. It is settled ECJ case law that, although, as EU law stands at present, direct taxation does not fall within the purview of the Union, the powers retained by the Member States must nevertheless be exercised consistently with EU law. This classic statement clearly reveals the conflict between two areas of legal competence of which the rules are more or less carved in stone. On the one hand, it is settled ECJ case law that EU law takes precedence over national law and that it has direct effect if its provisions are clear, precise and unconditional enough to be invoked and relied upon by individuals before national courts. The TFEU's provisions of free movement of goods, persons, services and capital meet the criteria of direct effect, so that any national tax measure which contravenes a free movement provision is rendered automatically inapplicable (the TFEU contains only a few possible exceptions which are almost never applicable to national direct tax rules). On the other hand, the Member States as a matter of principle retain extensive competences in tax matters. They remain free to determine the organization and conception of their tax system and to determine the need to allocate between themselves the power of taxation. Apart from these 'internal' objectives, the Member States are also at liberty to pursue 'external' objectives through tax measures such as the protection of the environment or stimulation of research and development.

The ECJ, called upon to interpret and apply the free movement provisions of the TFEU in direct taxation cases, has the difficult task of interpreting and applying the free movement provisions in relation to national direct tax measures. It seems obvious that a literal interpretation of the free movement provisions – without any further exceptions than the express Treaty derogations – would severely undermine the powers retained by the Member States in the field of direct taxation. In turn, not to apply the fundamental freedoms to direct taxation on the ground that the latter does not fall within the purview of EU law would deny the existence of the obligations to which the Member States have committed themselves when they concluded the TEU and the TFEU with the creation of an internal market as the primary objective. As a consequence, the ECJ has the difficult task of reconciling the consequences of the fiscal sovereignty retained by EU Member States with the obligations flowing from EU law.

In direct taxation cases, the ECJ generally uses the following model to assess whether a direct tax measure is a prohibited restriction on free movement:

1. Does the direct tax measure constitute a restriction on free movement?
2. If so, does the direct tax measure pursue a legitimate objective which is compatible with the TEU and the TFEU and is it justified by overriding reasons in the public interest?
3. If so, does the application of the direct tax measure ensure achievement of the aim pursued?

4. If so, does the application of the direct tax measure not go beyond what is necessary for that purpose?[794]

The approach taken in three of the four steps in the ECJ's model in direct taxation cases has received considerable criticism, discussed in second chapter of this study. In respect of the first step, tax literature is currently unable to explain why the ECJ does not distinguish dislocations from 'real' restrictions (the ECJ would thus not sufficiently respect a Member State's tax sovereignty); why international juridical double taxation does not lead to a restriction on free movement, and whether non-discriminatory national tax measures may amount to a *prima facie* restriction on free movement. In respect of the second step, tax literature is currently struggling with the question how to place the ECJ's justification analysis in a conceptual framework which goes beyond the necessarily coincidental fact patterns of the case law and which is apt to clarify the choices which the ECJ has made and is making. In particular, tax literature is struggling with the question of why the ECJ 'invents' certain justifications, why some justifications are accepted where others are not, and how to interpret these justifications. The third step is widely accepted. The fourth step, however, has led to considerable criticism. According to various authors, the application of this step in the case of *Marks & Spencer* had no basis whatsoever in EU law and amounts to positive integration for which the ECJ has no authority. More broadly, it is said that the ECJ does not understand the difficult area of tax law and it applies the free movement provisions in the area of direct taxation inconsistently and unclearly. As a result, neither national legislators nor taxpayers are able to tell which national tax measures are 'EU proof' and which are not.

In order to analyze whether this criticism is justified, this study has submitted that a proper analysis can only be made in the light of an assessment model which is external to and independent of the ECJ's current case law. This model should recognize that free movement and national direct tax sovereignty are fundamentally equal principles. One cannot say that free movement always prevails over national direct tax sovereignty. Nor can one say that national direct tax sovereignty always prevails over free movement.

It has been explained in chapter 3 that Robert Alexy's theory of principles is the best theory available to provide an assessment model. As discussed in chapter 4, this theory distinguishes rules from principles by examining what happens in case of a conflict between those norms. If two rules conflict with each other, the solution will be to disapply one of the rules. If two principles collide, however, the solution is not found by disapplying one of the principles, but by realizing both of them within what is factually and legally possible. Contrary to rules, principles are not definitive but only *prima facie* requirements. They typically lack the resources to determine their own extent, which should be assessed in the light of competing principles and what is factually possible. Thus, principles are optimization requirements. Their extent can be determined only in confrontation with another principle in the framework of an optimization model. This idea of the optimization of colliding principles perfectly fits the conflict between direct tax sovereignty and free movement. Sovereignty is to be framed as a principle and not as a rule in international

[794] E.g. Case C-527/06 *Renneberg*, § 81; Case C-446/03 *Marks & Spencer*, §35; Case C-196/04 *Cadbury Schweppes*, § 47.

law (chapter 5). The principle of sovereignty – a *prima facie* general freedom of action of States, as limited by international law – requires that its corollaries are realized within what is legally and factually possible. The extent of sovereignty, which can never be absolute, can be determined only in confrontation with other principles and rules. This confrontation can never lead to the disapplication of competing principles as such, but leads to the optimization of all interests involved under Alexy's theory of principles. The same applies to the principle of free movement in the EU's internal market (chapter 6). This principle *prima facie* protects a general freedom of (economic) action of persons. The extent of the principle of free movement can only be determined in confrontation with competing rules and principles. If it were otherwise, and its extent were unlimited, it would *de facto* deny that there is such a thing as sovereignty of Member States: it would prohibit taxation as such because taxation undoubtedly is an obstacle to free movement. Again, this confrontation between the two principles cannot lead to the disapplication of tax sovereignty, but the extent of the principle free movement should be determined through an optimization process. After all, both principles are of a fundamental equal weight. These notions have been developed further in chapters 4, 5 and 6, culminating in a theoretical optimization model in chapter 7:

1. To which *disadvantage* does the tax measure lead?
2. Does the tax measure at issue have a *respectful aim*?
3. If yes, is the tax measure *suitable* to achieve its aim?
4. If yes, does the tax measure have a sufficient *degree of fit* in relation to its aim?
5. If yes, does the tax measure reflect the most *subsidiary* means to achieve its aim?
6. If yes, is the cost to free movement caused by the tax measure *in proportion* to the aims pursued by it?

This model makes a normative claim as to how the conflict between free movement and tax sovereignty should be resolved in theory. It also makes a descriptive claim, because it enables scholars to structure and understand ECJ case law as a coherent body of law. It should be stressed that this study does not claim that the theoretical optimization model necessitates only one solution in an individual case. Rather, the model prescribes the method through which the problem should be solved, thus limiting the number of possible outcomes and structuring the analysis in a coherent manner. This makes it possible to predict certain future developments in the case law at a more general level which would at present be regarded as highly controversial.

The first phase of the model merely serves to identify to which disadvantage a certain direct tax measure leads. A court should be able to verify the *petitum* or claim of the taxpayer: which amount of tax should be refunded in the event that the court finds in favour of the taxpayer? In the case of legislative classifications on grounds of cross-border movement of the legal form of an establishment, it is clear that the disadvantage consists of the difference between the domestic situation and the other legal form. In respect of direct tax measures which do not make a distinction on grounds of cross-border activity, it depends on the type of the rule how the 'disadvantage' is identified. In respect of anti-abuse rules, for example, the disadvantage would consist of the difference between the tax due without these rules and the tax due after application of these rules. In respect of

taxation *as such*, the disadvantage would consist of the difference between the tax due and no taxation at all. Clearly, such a claim would generally not be sustained, because this would mean that the principle of free movement would not respect the principle of tax sovereignty as its limit; such a claim denies the very existence of a State's tax sovereignty. Disadvantages due to disparities in the tax systems of Member States are outside the scope of the theoretical optimization model altogether, because in these cases there is no conflict between the principles of direct tax sovereignty and free movement.

The second phase of the assessment model requires that the objective of a tax measure which leads to a disadvantage is respectful towards the principle of free movement. *Vice versa*, the principle of free movement should respect the principle of direct tax sovereignty. This idea of a 'twofold neutrality' means that direct tax measures should have an objective which is unrelated to the effect of the measure (i.e. an unequal tax treatment of domestic and cross-border situations or a general limitation on economic liberty). If a certain measure does not have a stated credible objective, it should be assumed that its objective coincides with its effects. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. This means that taxation *as such* is not disrespectful towards the principle of free movement.

The third phase of the assessment model concerns the test of 'suitability'. Once it has been ascertained that a measure which causes an identified disadvantage has a respectful objective, it should be assessed, factually, whether the measure is apt to attain its objective.

The fourth phase of the model examines the degree of fit or the over- and/or underinclusiveness of a classification. Overinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too widely. Underinclusiveness typically occurs when the group on which a particular burden is placed (or an advantage is granted) is defined too narrowly. It is important that the formulation of each classification matches as closely as possible the intended goal, because it should be avoided that persons unjustifiably fail to receive certain benefits or are unjustly burdened or disadvantaged. Tax measures which are, for instance, targeted at influencing the behaviour of individual taxpayers lead to a specific interference with the principle of free movement. This makes it possible to conduct a very specific examination of the degree of fit. For instance, in respect of measures of general tax policy aimed at achieving taxpayer equity, the Member State should have a wide margin of discretion. After all, the principle of free movement cannot impose a concept of its own of reasonable and correct law-making (e.g. the principle of free movement cannot prescribe where tax brackets should begin or end in an income tax system with progressive tax rates).

The test of subsidiarity requires that of two broadly equally suitable means, the one which interferes less intensively with the affected principle should be chosen. The requirement of subsidiarity does not address the way in which the classification is defined, but relates to the choice of the classification as a means of achieving the intended goal. The subsidiarity test examines whether it was actually necessary to make a distinction, aside from the question as to how this distinction is actually defined. Thus, the test of subsidiarity does not take the classification of the contested measure as a given, but requires that the

court more or less independently investigates the available alternatives which are equally suitable to achieve the objective pursued. This politically more sensitive task distinguishes the over- and underinclusiveness test from the subsidiarity test.

The sixth and last phase of the assessment model concerns the test of proportionality in the narrow sense (proportionality *stricto sensu*). It requires that the disadvantages caused by the measure should not be disproportionate to the aims pursued (a balance test). The greater the burden on the fundamental freedoms, the stronger the countervailing objective should be.

It has been examined in chapter 8 how the ECJ decides tax cases at present, how this practice fits into the theoretical optimization model and, to the extent that ECJ case law is insufficient to draw conclusions on the ECJ's stance on the model in direct taxation cases in certain situations, proposals have been made as to how the ECJ should decide these situations.

In respect of the first phase of the optimization model – the identification of a disadvantage – ECJ case law on disparities is in conformity with the model: in these cases there is no 'disadvantage' which can be optimized in the model (see *Gilly* and *Schempp*). In respect of international juridical double taxation, the absence of rules for the avoidance of such double taxation amounts to an identifiable 'disadvantage' under phase 1 of the model. The end result is however in line with ECJ case law, because it would be a disrespectful application of the principle of free movement if a Member State were to be forced to relieve international juridical double taxation (*Kerckhaert & Morres*). In respect of the concept of discrimination on grounds of the legal form of an establishment, ECJ case law is in conformity with the model: in these cases the disadvantage is related to the tax treatment of the other legal form (*CLT-UFA*). In respect of the concept of discrimination against cross-border activity, there is *in form* a difference between the theoretical optimization model and the ECJ's approach in direct tax cases. The ECJ formally employs a threshold criterion (a comparability test) in many direct tax cases before proportionality analysis can be performed. In fact, however, the ECJ uses a disadvantage test: a rule which taxes cross-border activity at a higher level than domestic activity constitutes a *prima facie* restriction on free movement. It is only after this has been established that the ECJ examines whether the two situations are objectively comparable (*X Holding*). This question must be answered in light of the object and purpose of the measure under consideration. This means that under current ECJ case law a tax disadvantage must be able to be explained by the (legitimate) object and purpose of the measure under consideration. This comes very close to the theoretical optimization model (phase 2: the requirement of a respectful aim). It is therefore not surprising that there is – apart from cases like *Columbus Container Services* and *D* – not much ECJ case law on direct taxation which directly contravenes the theoretical assessment model as far as the scope of the free movement provisions is concerned. This is also true in respect of situations of 'dislocation' or 'fragmentation' of the tax base which the ECJ does not distinguish from the concept of discrimination (*Bosal*, *Manninen*, *Marks & Spencer*). In respect of non-discriminatory tax obstacles to free movement, ECJ case law neither expressly confirms nor rejects the 'disadvantage' test of the theoretical optimization model (*Commission v. Belgium*, *Deutsche Shell*). It should be expected, however, that the ECJ will move in this direction, also because ECJ case law outside the area of direct taxation points in this direction.

The second phase of the theoretical optimization model requires that the tax measure which leads to a 'disadvantage' has a 'respectful aim' and that the EU free movement provision which affects this tax measure is respectful towards the principle of tax sovereignty as well. This means that direct tax measures should *in abstracto* 'accept' that they may be limited by the principle of free movement. In turn, the free movement provisions cannot lead to rules which would in fact have as their objective to do away with the principle of direct tax sovereignty: the principle of free movement should respect the internal and external objectives of national tax systems. No other requirements may be imposed, apart from being formally and substantively compatible with other principles enshrined in the TEU and the TFEU. ECJ case law in the area of direct taxation states that a restriction on free movement can be justified if either an express Treaty derogation applies or the tax measure at issue pursues a 'legitimate objective which is compatible with EU law' (this reflects the model's requirement of compatibility with other principles) and is 'justified by overriding reasons in the public interest'. Thus, a correct assessment of the objective of a tax measure is of the utmost importance under the theoretical optimization model. In line with this model, ECJ case law states that the objective of a national measure may be inferred *inter alia* from its legislative history and its effects (*Finalarte*). If a national measure pursues various objectives at the same time, one of which cannot be regarded as respectful, the other respectful measure may 'save' the measure (*Campus Oil*, *Nertsvoederfabriek*). This is also in line with the model. Once the objectives of a national tax measure are clear, it can be examined whether these are 'legitimate and compatible with EU law' and are 'justified by overriding reasons in the public interest'. According to settled ECJ case law, (tax) measures which discriminate directly on grounds of nationality cannot be justified unless a specific Treaty derogation applies (*Royal Bank of Scotland*). This is problematic in view of the theoretical optimization model: no principle can be absolute and any other rule or principle should be able to serve as its limit. Of course, a distinction directly on grounds of nationality may be subject to an intense review of the degree of fit of the measure, but an outright prohibition of such a distinction is not in line with the model. Tax measures which do not meet the ECJ's requirement that a restrictive tax measure has to pursue an objective which is 'legitimate' include measures which are motivated by budgetary reasons, practical difficulties, protection of the tax base, the existence of other tax advantages to compensate for the alleged tax disadvantage, the availability of an alternative legal or business form and the lack of EU harmonization concerning the impugned national tax measure. This can be explained by the theoretical optimization model, because the national tax measure disrespects the principle of free movement in these examples. ECJ case law also contains examples of situations where the principle of free movement is disrespectful towards the principle of tax sovereignty. A prohibition of taxation *as such* would, for example, be disrespectful (*Viacom Outdoor*, *Gilly*). It would also be disrespectful if the principle of free movement were to deprive the Member States of the possibility to determine the organization and aims of the tax system within their domestic jurisdiction (*Cadbury Schweppes*, *Oy AA*, *Test Claimants in the Thin Cap Group litigation*). If the objectives pursued by the national tax measures are misinterpreted or disrespected, bad case law is the result. Examples include *Fokus Bank*, *Amurta,* and *CLT-UFA*. In the vast majority of cases the ECJ however makes a correct assessment of the objectives of a national tax measure. If these objectives are compatible with other norms of EU law and

also respect the principle of free movement, the tax measure can serve as a limit to free movement. According to the theoretical optimization model, any objective whatsoever may serve as such. ECJ case law is in line with the model in this respect. Contrary to the classic requirement that a justification ground should be 'overriding', ECJ case law allows every thinkable objective as a justification for a restriction on free movement as long it is respectful towards free movement (*Orange European Smallcap Fund*).

The third phase of the theoretical optimization model requires that the national tax measures are suitable to achieve their objectives. ECJ case law is in line with this test, where it requires that for a restrictive tax measure to be justified, it must be appropriate for securing the attainment of the objective it pursues. Two cases where this test was not met apparently include *Bosal* and *Deutsche Shell*.

The fourth phase of the theoretical optimization model examines whether the national tax measure has a sufficient degree of fit in relation to its objective. At present, ECJ case law subsumes the assessment of the over- and/or underinclusiveness of a classification – the degree to which the definition of a classification matches the aim of the measure – under the necessity test (the application of a direct tax measure should not go beyond what is necessary for its purpose). Under the model, the requirement of a sufficient degree of fit should be distinguished from the subsidiarity of a certain classification (phase 5 of the model). Examples of underinclusiveness include *Manninen* and *Sardinia*. Examples of overinclusiveness include *Cadbury Schweppes* and *Test Claimants in the Thin Cap Group litigation*.

The fifth phase of the theoretical optimization model assesses whether the national tax measure reflects the most subsidiary means to achieve its objective. Would other, less restrictive measures have been available? The best-known examples of cases in which the subsidiarity test is applied by the ECJ concern direct tax measures which are in place because of an alleged lack of fiscal supervision in cross-border situations. This lack would justify a more burdensome taxation or would justify a reverse burden of proof. In intra-EU situations the ECJ normally counters these arguments by reference to Council Directive 77/799 which enables tax authorities to call upon the authorities of another Member State in order to obtain all the information that may be necessary to effect a correct assessment of a taxpayer's liability to tax. Thus, there are other measures available which enable the Member States to achieve the prevention of tax avoidance. Other examples of application of this test include *X&Y*, *Bachmann* and *Commission v. Belgium*. The case of *Lidl Belgium* shows that the ECJ is aware of the higher political sensitivity of the subsidiarity test in comparison with the requirement of a sufficient degree of fit. In this case, the ECJ should have decided that the objective of avoiding international juridical double taxation could have been achieved by less restrictive means, as indicated by the Commentaries to the OECD Model Tax Convention. The subsidiarity test was also misapplied in *X Holding*.

The sixth phase of the theoretical assessment model contains the requirement of proportionality in the narrow sense of the term: the disadvantage caused by the direct tax measure should not be disproportionate in relation to the interests of the internal market. It is a balancing exercise between national interests and interests of the Union. Although the ECJ has not explicitly applied this test in its direct tax case law, there is clear evidence in case law such as *Marks & Spencer* and *N* that the ECJ has used it in practice to avoid black-and-white consequences of restrictive measures which are, in principle, justified. This is

completely in line with the theoretical assessment model. The often-heard complaint that the ECJ has overstepped its competence in this respect is, therefore, unjustified.

The conceptual framework developed in the present study makes it possible to structure, understand, assess and – at a more general level – predict ECJ case law in the area of direct taxation. The table in the annex to this study shows that the vast majority of ECJ judgments can be explained by the theoretical optimization model. The severe criticism of the ECJ is, therefore, largely unjustified. Hopefully, the theoretical optimization model will serve as a useful tool for both scholars and courts.

10. Table of direct taxation and free movement cases under the theoretical optimization model

Case	Name	End result in line with the model?	Reference
270/83	Avoir Fiscal	Yes	8.2.1.4; 8.3.1.4; 8.3.2.3
81/87	Daily Mail	n/a	2.2.4
175/88	Biehl	Yes	2.2.4; 8.3.1.4
C-204/90	Bachmann	Yes	8.6.1; 8.6.2
C-300/90	Comm. v. Belgium	Yes	8.6.1
C-112/91	Werner	n/a	2.1
C-330/91	Commerzbank	Yes	8.3.2.4
C-1/93	Halliburton	Yes	8.2.1
C-279/93	Schumacker	Yes	2.2.4; 8.2.1.4; 8.2.2.5; 8.2.3.2
C-484/93	Svensson	Yes	8.3.2.3
C-80/94	Wielockx	Yes	8.2.1.4
C-107/94	Asscher	Yes	2.2.4; 6.4
C-151/94	Biehl II	Yes	2.2.4
C-250/95	Futura	Yes	8.2.1.4; 8.2.2.5; 8.2.3.2
C-118/96	Safir	Yes	8.6.1
C-264/96	ICI	Yes	2.2.4
C-336/96	Gilly	n/a	2.2.4; 8.2.1.2; 8.2.2.2; 8.3.2.4
C-254/97	Baxter	Yes	2.2.4; 8.3.1.4
C-294/97	Eurowings	Yes	8.3.2.3
C-307/97	Saint-Gobain	Yes	2.2.4; 8.2.1.1; 8.2.1.4
C-311/97	RBS	Yes	8.2.1.4; 8.3.1.3; 8.3.2.3
C-391/97	Gschwind	Yes	8.2.1.4
C-439/97	Sandoz	Yes	8.2.1.5
C-35/98	Verkooijen	Yes	2.2.4
C-55/98	Vestergaard	Yes	8.6.1
C-200/98	X AB & Y AB	Yes	2.2.4; 8.3.1.4
C-251/98	Baars	Yes	2.2.4
C-397/98	Metallgesellschaft	Yes	8.3.2.2
C-141/99	AMID	Yes	8.2.1.4; 8.2.2.4
C-136/00	Danner	Yes	8.3.2.3
C-324/00	Lankhorst	Yes	2.2.4
C-385/00	De Groot	Yes	8.2.1.4; 8.2.2.4
C-436/00	X & Y	Yes	2.2.4; 8.6.1; 8.6.2
C-168/01	Bosal	Yes	2.2.5; 8.2.1.4; 8.4.1; 8.4.2
C-234/01	Gerritse	Yes	2.2.4; 8.2.1.4; 8.2.2.5
C-364/01	Barbier	Yes	2.2.4
C-422/01	Skandia	Yes	8.6.1
C-9/02	Lasteyrie du Saillant	Yes	2.2.4
C-42/02	Lindman	Yes	2.2.4

C-315/02	Lenz	Yes	2.2.4
C-319/02	Manninen	Yes	2.2.5; 2.3; 7.4.4; 8.2.2.3; 8.3.1.4; 8.3.2.5; 8.5.1
C-334/02	Fixed levy	Yes	2.2.4
C-152/03	Ritter	Yes	8.2.1.4
C-169/03	Wallentin	Yes	8.2.1.4
C-242/03	Weidert & Paulus	Yes	2.2.4
C-253/03	CLT-UFA	No	8.2.1.1; 8.2.1.4; 8.3.2.4
C-268/03	De Baeck	Yes	2.2.4
C-376/03	D	No	8.2.1.4; 8.2.2.1; 8.2.2.5
C-403/03	Schempp	n/a	2.2.4; 2.2.5; 8.2.1.2
C-446/03	Marks & Spencer	Yes	2.2.5; 2.3; 2.4; 7.4.1; 7.8; 8.2.1.4; 8.3.2.4; 8.3.2.5;
C-512/03	Blanckaert	Yes	2.2.4; 8.2.1.5
C-513/03	Van Hilten	Yes	8.2.2.3
C-39/04	Laboratoires Fournier	Yes	7.4.5; 8.3.1.4
C-150/04	Comm. v. Denmark	Yes	8.6.1
C-196/04	Cadbury Schweppes	Yes	2.2.4; 8.2.1.4; 8.2.2.5; 8.3.1.4; 8.3.2.2; 8.5.2
C-265/04	Bouanich	Yes	2.2.4; 8.2.1.4
C-290/04	Scorpio	Yes	2.2.4
C-292/04	Meilicke	Yes	2.2.4; 8.3.2.4
C-345/04	Centro Equestre	Yes	2.2.4; 8.2.1.4
C-346/04	Conijn	Yes	8.2.1.4
C-347/04	Rewe Zentralfinanz	Yes	2.2.5; 8.3.1.2
C-374/04	ACT GLO	Yes	2.2.4; 8.2.2.1; 8.2.1.4; 8.4.2
C-386/04	Stauffer	Yes	2.2.4
C-433/04	Comm. v. Belgium	Yes	8.2.1.1; 8.2.1.5; 8.2.2.7; 8.6.1; 8.6.2
C-446/04	FII GLO	Yes	2.2.5; 8.2.1.4; 8.2.2.5
C-470/04	N	Yes	2.2.4; 2.2.5; 8.2.1.4; 8.7.1
C-471/04	Keller	Yes	2.2.5
C-492/04	Lasertec	n/a	2.2.1
C-513/04	Kerckhaert & Morres	Yes	2.2.4; 2.2.5; 8.2.1.3; 8.2.2.4
C-520/04	Turpeinen	Yes	2.2.4
C-522/04	Comm. v. Belgium	Yes	2.2.4
C-524/04	Thin Cap GLO	Yes	2.2.4; 8.2.1.1; 8.2.3.3; 8.5.1; 8.5.2
C-76/05	Schwarz	Yes	2.2.4
C-101/05	A	Yes	8.6.1
C-102/05	A and B	n/a	2.2.1
C-152/05	Comm. v. Germany	Yes	8.5.1
C-157/05	Holböck	n/a	2.2.1
C-170/05	Denkavit	Yes	2.2.4; 8.3.2.4
C-201/05	CFC GLO	Yes	2.2.4
C-231/05	Oy AA	Yes	2.2.4; 2.2.5; 4.5.2; 7.4.4; 7.8; 8.2.1.1; 8.2.1.4; 8.2.2.1; 8.2.2.5; 8.3.1.4; 8.3.2.3; 8.7.1
C-298/05	Columbus	No	2.2.4; 8.2.1.1; 8.2.1.3; 8.2.1.4; 8.2.1.1; 8.2.2.4; 8.2.2.5; 8.2.3.3
C-318/05	Comm. v. Germany	Yes	2.2.4
C-329/05	Meindl	Yes	8.2.1.4
C-345/05	Comm. v. Portugal	Yes	2.2.4
C-379/05	Amurta	No	2.2.4; 8.3.2.4
C-383/05	Talotta	Yes	2.2.4
C-427/05	Porto Antico di Genova	Yes	2.2.4; 8.2.1.2
C-451/05	ELISA	Yes	8.2.3.3
C-464/05	Geurts and Vogten	Yes	2.2.4; 8.2.2.5
C-104/06	Comm. v. Sweden	Yes	2.2.4
C-182/06	Lakebrink	Yes	8.2.1.4; 8.3.2.3

C-194/06	OESF	Yes	2.2.4; 5.4.2; 8.2.1.3; 8.2.1.4; 8.2.2.3; 8.2.2.4; 8.3.2.5; 8.4.1
C-248/06	Comm. v. Spain	Yes	8.3.1.4
C-256/06	Jäger	Yes	2.2.4
C-281/06	Jundt	Yes	8.3.1.4
C-284/06	Burda	Yes	8.2.1.4
C-293/06	Deutsche Shell	Yes	2.2.4; 8.2.1.1; 8.2.1.5; 8.2.2.4; 8.2.2.7; 8.2.3.3; 8.3.2.3; 8.4.1; 8.4.2
C-360/06	Bauer	Yes	2.2.4
C-414/06	Lidl Belgium	No	2.2.4; 2.2.5; 8.2.1.4; 8.6.1; 8.6.2
C-415/06	SEW	n/a	2.2.1
C-436/06	Grønfeldt	Yes	2.2.4
C-443/06	Hollman	Yes	2.2.4
C-11/07	Eckelkamp	Yes	2.2.4
C-43/07	Arens-Sikken	Yes	2.2.4
C-48/07	Les Vergers du Vieux Tauves	Yes	2.2.4
C-105/07	Lammers & van Cleef	Yes	2.2.4
C-157/07	Krankenheim	Yes	8.2.1.4; 8.2.2.4
C-282/07	Truck Center	Yes	2.2.4
C-303/07	Aberdeen	Yes	2.2.4
C-318/07	Persche	Yes	2.2.4; 8.4.1; 8.6.1
C-330/07	Jobra	Yes	2.2.4
C-377/07	STEKO	Yes	
C-406/07	Comm. v. Greece	Yes	2.2.4
C-418/07	Papillon	Yes	2.2.4; 8.3.1.4; 8.3.2.5
C-439/07	KBC Bank	Yes	2.2.4; 8.2.1.1; 8.2.1.4
C-521/07	Comm. v. Netherlands	Yes	
C-527/07	Renneberg	Yes	2.2.5; 8.2.1.4; 8.2.2.5; 8.2.3.2
C-540/07	Comm. v. Italy	No	2.2.4; 8.3.2.4
C-544/07	Rüffler	Yes	2.2.4
C-562/07	Comm. v. Spain	Yes	2.2.4
C-35/08	Busley and Cibrian	Yes	8.2.1.4
C-67/08	Block	Yes	2.2.4; 8.2.1.3
C-96/08	CIBA	Yes	8.3.2.3
C-105/08	Comm. v. Portugal	n/a	2.2.4
C-128/08	Damseaux	Yes	2.2.4
C-153/08	Comm. v. Spain	Yes	2.2.4
C-155/08 / C-157/08	X and Passenheim – van Schoot	Yes	8.6.1
C-169/08	Sardinia	Yes	8.5.1; 8.5.2
C-182/08	Glaxo Wellcome	Yes	8.2.1.4
C-311/08	SGI	Yes	2.2.4
C-436/08	Haribo	No	8.2.1.4; 8.2.2.4; 8.2.2.5
C-337/08	X Holding	No	2.2.4; 8.2.1.4; 8.2.2.1; 8.6.1; 8.6.2
C-440/08	Gielen	Yes	8.2.1.4
C-487/08	Comm. v. Spain	No	8.3.2.4
C-510/08	Mattner	Yes	2.2.4
C-20/09	Comm. v Portugal	Yes	2.2.4
C-72/09	Rimbaud	No	8.6.1
C-155/09	Comm. v. Greece	Yes	8.3.1.3
C-262/09	Meilicke II	Yes	8.3.2.4
C-233/09	Dijkman	Yes	2.2.4
C-267/09	Comm. v. Portugal	Yes	2.2.4

C-384/09	Prunus	Yes	2.2.4
C-450/09	Schröder	Yes	8.2.1.4
C-10/10	Comm. v. Austria	Yes	8.3.1.4
C-25/10	Heukelbach	Yes	2.2.4
C-287/10	Tankreederei	Yes	2.2.4
E-1/04	Fokus Bank	No	2.2.4; 8.3.2.4
E-7/07	Seabrokers	Yes	8.2.1.4; 8.2.2.4; 8.2.2.5

Samenvatting

Optimalisering van fiscale soevereiniteit en vrij verkeer

Hoewel de directe belastingen tot de bevoegdheid van de EU-lidstaten zijn blijven behoren, moeten de lidstaten deze bevoegdheid desalniettemin uitoefenen in overeenstemming met het recht van de Unie. Deze vaste jurisprudentie van het Hof van Justitie van de Europese Unie (hierna: HvJ EU) laat het conflict tussen nationale fiscale soevereiniteit en de Europese vrijverkeersbepalingen duidelijk zien. Aan de ene kant zijn de lidstaten bevoegd te bepalen wie binnen hun belastingjurisdictie subjectief belastingplichtig is, wat de belastinggrondslag is en hoe hoog het belastingtarief is. Aan de andere kant mogen de lidstaten geen obstakels invoeren die de uitoefening van het vrije verkeer van goederen, personen, diensten en kapitaal binnen de Unie minder aantrekkelijk kunnen maken. Het HvJ EU ziet zich geplaatst voor de moeilijke taak deze tegengestelde uitgangspunten met elkaar te verzoenen. Inmiddels heeft het HvJ EU ruim 150 arresten gewezen die op deze problematiek betrekking hebben. Deze arresten zijn bepaald niet zonder kritiek gebleven, zoals de in hoofdstuk 2 besproken literatuur laat zien. Het HvJ EU zou volgens sommige auteurs teveel inbreuk maken op de fiscale soevereiniteit van de lidstaten. Het zou het moeilijke (internationale) belastingrecht niet begrijpen. Het zou zich bezondigen aan positieve harmonisatie op fiscaal terrein, hetgeen exclusief tot de bevoegdheid van de lidstaten zou behoren. Andere auteurs, vooral in recentere jaren, zijn van mening dat het HvJ EU juist te veel ontzag heeft voor nationale fiscale soevereiniteit. Het zou ten onrechte hebben geoordeeld dat lidstaten geen EU-rechtelijke verplichting hebben internationaal juridisch dubbele belasting te voorkomen. Weer andere schrijvers hebben betoogd dat de rechtspraak van het HvJ EU op het terrein van de directe belastingen inconsistent en onduidelijk is, zodat belastingplichtigen noch nationale fiscale wetgevers zouden weten waar zij aan toe zijn. Dit proefschrift beoogt orde te scheppen zowel in de rechtspraak van het HvJ EU als in de zojuist verwoorde verschillende meningen. Het doet dit door een toetsingsmodel te ontwerpen dat los staat van deze rechtspraak en literatuur. In hoofdstuk 3 wordt toegelicht waarom Alexy's *Theory of Constitutional Rights* het beste denkraam biedt om het conflict tussen fiscale soevereiniteit en vrij verkeer tegemoet te treden. In hoofdstuk 4 wordt besproken dat de kern van Alexy's theorie inhoudt dat beginselen alleen *prima facie* bestaan. De aard van beginselen is hierin gelegen dat zij eisen dat een bepaalde waarde of een bepaald idee zoveel als feitelijk en juridisch mogelijk is wordt gerealiseerd. Ook regels kunnen *prima facie* bestaan. Als een regel in strijd is met een bepaald beginsel, kan het noodzakelijk zijn de regel in bepaalde gevallen niet (geheel) toe te passen. Er is echter één belangrijk verschil tussen regels en beginselen: een regel is vastgesteld door een bevoegde autoriteit. Formele beginselen, zoals een toetsingsverbod, kunnen het onmogelijk maken de regel aan te passen. Bij het conflict tussen fiscale soevereiniteit en vrij verkeer speelt dit probleem niet, zodat nationale belastingmaatregelen en de vrijverkeersbepalingen kunnen worden betrokken in een Alexiaans optimaliseringsproces.

In dit kader moet worden vastgesteld dat de beginselen van fiscale soevereiniteit en vrij verkeer fundamenteel gelijkwaardig zijn; het is niet mogelijk om in het algemeen te zeggen dat één beginsel belangrijker is dan het andere. Bij een botsing moet van geval tot geval worden beoordeeld in hoeverre zij tot gelding kunnen komen. Hierbij is van belang dat de botsende beginselen van elkaar accepteren dat zij wederzijds elkaars gelding beperken. Een beginsel kan derhalve niet zo worden opgevat dat het een ander beginsel in elk geval zou overrulen. In hoofdstuk 5 wordt betoogd dat fiscale soevereiniteit het beginsel weerspiegelt dat een Staat een zo groot mogelijke handelingsvrijheid heeft. Het beginsel van vrij verkeer streeft uiteindelijk naar een Europese interne markt zonder enig fiscaal obstakel voor het vrije verkeer van goederen, personen, diensten en kapitaal (hoofdstuk 6). Onverkorte uitvoering van één van beide beginselen zou leiden tot de non-existentie van het andere beginsel. Het conflict tussen beide beginselen moet dus worden opgelost in een optimaliseringsproces. Waar ligt het punt waar beide beginselen zoveel mogelijk tot hun recht komen? Om deze vraag te kunnen beantwoorden wordt in hoofdstuk 7 een theoretisch optimaliseringsmodel neergelegd dat de volgende stappen bevat:

1. Tot welk *nadeel* leidt de belastingmaatregel?
2. Streeft de belastingmaatregel in kwestie een *respectvol doel* na?
3. Zo ja, is de belastingmaatregel *geschikt* om dat doel te bereiken?
4. Zo ja, heeft de belastingmaatregel een voldoende *degree of fit* in relatie tot haar doel?
5. Zo ja, behelst de belastingmaatregel het meest *subsidiaire* middel om het doel te bereiken?
6. Zo ja, staat de inbreuk die de belastingmaatregel maakt op het vrije verkeer in een redelijk *evenwicht* tot het nagestreefde doel?

Dit model is normatief van aard in die zin dat het voorschrijft hoe het conflict tussen de beginselen van fiscale soevereiniteit en vrij verkeer in theorie zou moeten worden opgelost. Het model is descriptief van aard in die zin dat het wetenschappers in staat stelt de rechtspraak van het HvJ EU te begrijpen en te structureren als een coherent geheel. Het zij benadrukt dat het model niet de pretentie heeft dat in ieder individueel geval noodzakelijkerwijs één specifieke uitkomst moet worden bereikt. Wel schrijft het model voor op welke wijze het probleem moet worden aangevlogen, waardoor het aantal mogelijke uitkomsten wordt beperkt en de analyse op coherente wijze wordt gestructureerd. Dit maakt het ook mogelijk om op een iets hoger abstractieniveau voorspellingen te doen over toekomstige ontwikkelingen in de rechtspraak die thans als zeer controversieel worden gezien. De belangrijkste hiervan is dat het HvJ EU ook non-discrimatoire belastingmaatregelen die de uitoefening van het vrije verkeer minder aantrekkelijk maken binnen de reikwijdte van het vrije verkeer zal brengen. In hoofdstuk 8 wordt het model toegepast op geselecteerde arresten van het HvJ EU. Het blijkt dat de rechtspraak van het HvJ EU op het terrein van de directe belastingen en vrij verkeer tamelijk coherent is indien zij wordt beoordeeld en bekeken vanuit het theoretische optimaliseringsmodel. Mogelijk kan het model dienen om in de toekomst betere en meer gestructureerde kritiek te leveren op het HvJ EU, want veel van de huidige kritiek lijkt niet geheel terecht te zijn.

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